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Finance Guide

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Galaxy



Featured Book Review

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The Many Forms of Profitability A Zen-Like Dialogue About How Businesses Make Money

Review by Barry Silverstein

How can you write about profitability and make the information that must be conveyed compelling and engaging instead of dry textbook-like prose? Zen is the answer.

In this uniquely structured book, Adrian Slywotzky borrows a technique that is as old as storytelling itself — that of the master teacher interacting with his student. A number of business books over the years have used parables, fables and teacher-student relationships as their basis.

The technique works over and over again — witness business best sellers such as *The One Minute Manager*, *Who Moved My Cheese?* and *The Five Dysfunctions of a Team*.

Other business books have conceptually incorporated Zen philosophy, with some titles stretching the concept to absurdity; *White Collar Zen* and *Z.B.A.: Zen of Business Administration* are two such examples. But *The Art of Profitability* does a fine job of combining storytelling with Zen elements to illustrate the myriad forms of business profitability — and there are surprisingly many of them.

When the Student Meets the Teacher

Slywotzky, a management consultant, has authored or co-authored three books on business profitability and value and one book on digital business, so he is more than qualified to write about profitability. Clearly, he was looking for a different way to do it, and perhaps the format of the book reveals a frustrated novelist lurking within.

Slywotzky begins the profitability journey with a gentle warning, advising the reader to read only one chapter per week. The reason is to achieve Zen-like focus on a particular form of profitability and to think

about its applications to the reader's own situation. It is advice well-heeded, for the deceptively simple chapters reveal a great deal worthy of study and thought.

The premise of the book is that Steve Gardner, a young strategic planner for a diversified company called Delmore, is anxious to learn about profitability. He is introduced to someone at a cocktail party who refers Gardner to David Zhao.

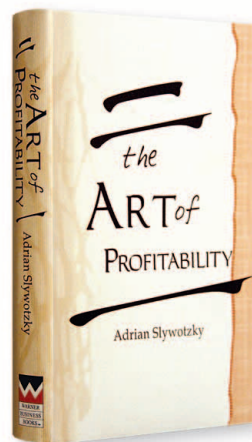
Gardner meets Zhao on a Saturday morning at an unlikely place — Zhao's office at a law firm. Zhao explains that he is employed by the firm not as an attorney, but rather as someone who consults on business structure. Zhao agrees to teach Gardner about profitability under the following conditions:

- The two will meet most Saturday mornings between September and May at Zhao's office for one hour.
- Gardner will be expected to spend four hours per week reading and preparing.
- Zhao will charge Gardner \$1,000 per lesson.

Gardner agrees, but is shocked by the final condition. He tells Zhao he cannot afford it. Zhao's answer is telling of what is to come: "I'm not asking for the money now. You can pay the fee when you're able to — if you ever are."

Twenty-Three Flavors and Maybe More

Each chapter of the book comprises a lesson, and each lesson is basically a dialogue between Zhao and Gardner. We learn in Chapter 1 that Zhao intends to cover 23 profit models. Zhao tells Gardner the number is arbitrary, but signals to the reader a shifting perspective: Most businesspeople do not view prof-



THE ART OF PROFITABILITY
by Adrian Slywotzky
Published by Warner Books, Copyright © 2002, 254 pages, \$20.00

“... profitability is, indeed, an art and not a science. As much as it is based on numbers, and follows certain rules, profitability is fragile, fluid and not all black-and-white.”

itability as multi-dimensional.

As the 23 profit models unfold, Zhao challenges Gardner with increasingly difficult questions, asks him to do selected readings and provides him with assignments.

Zhao often restrains himself from giving Gardner the answers, instead guiding him to expand his thinking. We see the classic master/disciple relationship developing.

Slywotzky has Zhao explain each of the profit models in uncomplicated terms, using clear, concrete examples. For most models, Slywotzky adds a nice technique — having Zhao draw an elegantly simple diagram that defines the model in visual terms. (The drawings are done in broad Zen-like brush strokes.) In later lessons, we see Gardner begin to draw diagrams himself — suggesting that he has reached a deeper level of understanding.

Slywotzky also ensures that Zhao addresses the differences, similarities and overlaps of the models, lest the reader think that each is a tidy stand-alone concept.

This is an important underlying thread of the book: Slywotzky wants the reader to comprehend that profitability is an art and not a science. As much as it is based on numbers and follows certain rules, profitability is fragile, fluid and not all black-and-white. Higher profitability is defined not only by the result of expenses versus income, but by various business strategies.

The very existence of multiple profit models proves the complexity of the subject. As Zhao and his student discuss the nuances of the profit models, we move away from a singular view of profitability and recognize we are dealing with subject matter that is deep and rich in its dimensions.

What Do the Models Look Like?

Are there really 23 different profit models? While the reader may perceive that some of the models are simply variations of others, it is interesting nonetheless to consider the vastness of Slywotzky's view of profitability.

Most readers will recognize “Customer Solution Profit,” wherein a company invests the time and energy necessary to learn everything about its customers and then uses that knowledge to create tailored solutions just for them. This model demands high costs upfront and results in initially low profitability, but over time, costs drop dramatically and the company can go into maintenance mode. As a result, profit increases significantly in the later stages. As

Gardner puts it: “Lose money for a short time. Make money for a long time.”

Readers will also understand “Pyramid Profit,” but they may not have thought about it as “the Barbie strategy.” Zhao offers Gardner an example of Mattel's pyramid strategy with Barbie. Zhao calls Barbie “a system — a carefully crafted, coordinated and integrated system.” He explains that the low-end, low-cost Barbie that appeals to children is “a firewall of defensive product at the bottom of the pyramid” that blocks out competitors. The high-end, high-cost Barbie, a quality collectible targeted to adults, represents “a powerful profit-generator at the top.” Zhao points out that the successful implementer of the Pyramid Profit model “must understand all of the customers, current and potential.”

“Multi-Component Profit” is well-illustrated by Coca-Cola, a single product that is sold in multiple venues. Coke can be purchased by the consumer in a grocery store, at a restaurant and from a vending machine. Each time, the cost per ounce differs, yet the consumer actu-



ally buys the product at every price point, depending on where he or she happens to be at any given time.

“Switchboard Profit” is one of the more intriguing models due to its concentration of power. Zhao uses the Hollywood agent Michael Ovitz to illustrate the concept. He says Ovitz first packaged talent, then worked with a literary agent to get stories and ultimately put the talent and the stories together to sell to movie studios. Gardner correctly suggests that the real profitability came when Ovitz reached critical mass. Ovitz sought to represent many individuals — movie stars, writers and directors — all of whom were hot commodities to the studios. By pitching a complete package, Ovitz was able to command even higher fees from the studios and get even more stars to sign on with him because of his success.

“Digital Profit” is perhaps the most enticing profit model because it can result in a tenfold increase in productivity, while allowing the digital company’s customers to design their own products and even solve their own problems online. The digital profit model also allows companies to get information much faster — so they can make decisions that impact profitability much sooner.

Some of the other profit models are more abstract, however, and not as easy to differentiate. Slywotzky acknowledges this in the fictional dialogue, as teacher and student discuss and sometimes debate the profit models.

Zhao calls some of the models “first cousins.” At one point, Zhao asks Gardner to detail the differences among “Time Profit,” “New Product Profit” and “Specialty Product Profit.” The chart that Gardner creates for his own clarification also helps the reader better understand the subtle nuances of these three profit models.

By the last lesson, Gardner has not only learned the 23 profit models, he has uncovered the secret of Zhao’s teaching methodology. He realizes that the sequence of the lessons was not random. He sees that while Zhao begins his conclusion with the traditional, oldest profit models, the teacher’s final profit model

is the newest — one that can be used to achieve great success without even being a big business. He realizes that Zhao did not place the “first cousins” together, so that Gardner does not fall into the trap of focusing on the similarities rather than the differences.

We also learn in the last lesson that Gardner has been offered a promotion at Delmore — the position of vice president at the company’s paper division, which he helped revitalize through applying some of his lessons with Zhao. He tells Zhao he will not accept the offer, however, because he wants to continue to strategize for many businesses. Gardner explains: “There are some doors we’re not meant to walk through. I’m pretty sure this is one of those.”

Pearls of Wisdom

Zen master teachers are known for imparting wisdom that is both universal and introspective. Their role is to lead students to self-realization and spiritual awakening.

Slywotzky does an admirable job of having his character Zhao be both business teacher and spiritual guide to Gardner.

Zhao’s salient observations are peppered throughout the text. Gardner also verbalizes some key concepts. Here is a sampling of their collective wisdom:

- “You have to have a genuine, honest-to-goodness interest in profitability.”

- “Different parts of a business can have wildly different profitability.”

- “Sometimes it’s useful for a teacher to stand in exactly the same place as his student.”

“‘Digital Profit’ is perhaps the most enticing profit model because it can result in a tenfold increase in productivity, while allowing customers to design their own products online.”



● “The hardest thing in business is to keep the entrepreneurial spirit alive and flourishing in the wake of continued success.”

● “Profitability is thinking differently, always asking: ‘How does the high profit happen?’”

How Profitability Comes Alive

Several additional concepts are at work in the book to make profitability come alive. Throughout the weeks and months, Gardner discusses his own experiences, both positive and negative, at Delmore. We see a picture of the fictional company emerging that could represent a company the reader works for or is familiar with. Each division of Delmore is discussed in the context of Zhao’s lessons. Zhao comments on the company and seems to have the uncanny ability to know about things before they happen. Gardner’s own trials and tribulations at Delmore depict the challenges faced by a diversified company in many lines of business.

Gardner applies what he learns at some of the sessions with Zhao to his position at Delmore with varying success. Gardner gets to see that profitability is complex, ever-changing and dependent on an individual company’s management, lines of business and business conditions. There are no easy answers — a point that becomes painfully clear to both Gardner and the reader.

Zhao frequently uses examples to illustrate the profit models. While the character may be imaginary, the stories he relates about companies are real. These illustrative anecdotes provide depth and insight into each profit model and make it easier to understand the concepts and see how they apply to the real business world.

The author cleverly weaves required readings into the text, as Zhao chooses articles and books for Gardner that are pertinent to each lesson. A wise reader will pick up the cues and read the books Zhao recommends to his student. (An even wiser reader might do the readings in the same order prescribed for the student.) Some of the titles seem odd at first

— *Einstein’s Dreams* by Alan Lightman and *ABC of Reading* by Ezra Pound, for example. Others seem self-serving — Slywotzky includes all of his own books on the required reading list. Nonetheless, every book Zhao mentions is selected for a specific reason, and the teacher enlightens his student, and the reader, as to its relevance.

The dialogue and interactions between teacher and student make what could be ponderous subject matter engaging and readable. We witness the inscrutability of the master teacher and the impatience of the student thirsting for knowledge. We notice Zhao’s ability to read his student, and his pointed use of silence to provoke his student’s responses and encourage critical thinking. We see Gardner’s ability to think expansively grow over the months. We admire the way Gardner has matured by the end of the book, as he turns around the relationship and asks his own insightful questions of his teacher. ■

What’s Special About This Book

Slywotzky demonstrates that the art of profitability is a multi-faceted subject deserving serious study. He has the ability to succinctly explain each of twenty-three profit models in just enough detail, while suggesting that there is much more to learn.

Through Zhao the master teacher, the reader delves into the economics of profitability. More important, however, is the strategic insight shared by Zhao and, increasingly, by his student as the book progresses.

While some of the story line may seem forced, the overall effect of the book’s structure makes the topic enjoyable, easy reading. This is a book that is at once simple and complex, revealing in its many layers how readers can make their companies highly profitable. *The Art of Profitability* is a book that can be read many times and will have lasting value.

The author: Adrian Slywotzky is vice president and member of the board of directors of Mercer Management Consulting, Inc. He has worked extensively at the CEO level for major corporations on issues relating to new business development and creating new areas of value growth.

He is the author of *Value Migration: How To Think Several Moves Ahead of the Competition* and has co-authored a number of books. Slywotzky holds degrees from Harvard College, Harvard Law School and the Harvard Business School.

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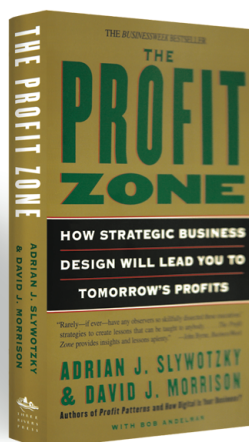
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SOUNDVIEW Executive Book Summaries®



by Adrian J. Slywotzky
and David J. Morrison

How Strategic Business Design Will Lead You to Tomorrow's Profits

THE PROFIT ZONE

THE SUMMARY IN BRIEF

The No. 1 problem in business today is profitability. Where is the profit zone today? Where will it be tomorrow? The profit zone is the area of your economic neighborhood where you are allowed to earn a profit. To reach and operate in the profit zone is the goal of every company.

The quest for profitability has become more important than ever. The hype of the Internet, the free flow of excess venture capital and the strength of the equity markets have collaborated to create many foolish business models. This increases the need for the discipline of business design reinvention.

We're looking forward to the real possibility of a sustained period of low profit and low growth for all the thousands of businesses that don't understand where tomorrow's profit will come from — and how to reinvent their obsolete business designs accordingly.

By studying the examples of great business reinventors — such as Jack Welch, Charles Schwab, Michael Eisner, Bill Gates and several others — you will be able to create value for your customers and capture value for your business. Each of the reinventors have been extraordinarily successful at using carefully chosen tactics to create exceptional profit growth for his company.

By developing superior insight into customers and adapting a company's business design accordingly, business leaders can get off the treadmill of just doing the same old things faster and better and return to the profit zone. This summary answers the most fundamental question in business: Where will I make a profit tomorrow?

IN THIS SUMMARY, YOU WILL LEARN:

- How to protect your profitability.
- Why market share is dead.
- How to design a customer-centric business that leads to profit.
- About 11 different profitability models that can be used to achieve various profit-centric business designs.
- About the business leaders and companies who have led the way in reinventing their business design and how they succeeded.
- How business design innovation creates the profit zone.

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THE COMPLETE SUMMARY: THE PROFIT ZONE

by Adrian J. Slywotzky and David J. Morrison

Market Share Is Dead

As a manager, you were taught that the pursuit of market share and growth automatically places you on a direct route to business success. However, these formerly direct roads have become mazes riddled with traps, wrong turns and dead ends. Many large companies, after taking the turn toward market share and volume growth, have only hit a profitless wall.

Consider the experience of IBM, DEC, GM, Ford, United Airlines, US Steel, Kodak, Sears and Kmart. All achieved leading market share positions: No. 1 or No. 2 in their industries. Yet all these leaders saw their profitability begin to erode during the 1980s. Their dominant share positions did not protect them. Several of these companies have since implemented radical changes in their business design. Their focus on profit, not just market share, has led to dramatic rebounds in value.

Managing for Volume Growth or Value Growth?

In the old economic order, in the age of market share, volume growth was a guarantor of success. Growth was what we were taught to pursue. It created higher profits for all, including market share laggards, companies with poor business designs and companies that were poorly managed. A rising tide raised all boats.

However, industry growth and a company's value (stock price) growth no longer have a one-to-one correlation. Fast-growing industries such as consumer electronics, telecommunications and software have each produced scores of terminally unprofitable companies. By contrast, Coca-Cola achieved significant value growth in the low-growth beverage industry, as did General Electric in a collection of low-growth manufacturing industries.

No-Profit Zones

No-profit zones are the black holes of the business universe. In a physical black hole, light waves go in but never come back out. In an economic black hole, investment dollars go in, but the profit dollars never come back out. Paradoxically, the devout pursuit of market share may be the single greatest creator of no-profit zones in the economy. ■

Customer-Centric Business Design

Let's begin with what customer-centric thinking isn't. It isn't traditional, conventional market research — mountains of data, hundreds of tables and no actionable insight. Nor is it traditional customer satisfaction research, an important but backward-looking measurement of how yesterday's decision makers rated us on what was important in yesterday's business model.

By contrast, customer-centric thinking needs to look at the customers' problems through the customers' eyes, not through the eyes of a market researcher. The customer-centric thinker spends time talking to customers rather than reading reports and thereby gains an understanding of the customer's perspective.

Customer-centric thinking is difficult for two reasons. First, managers and executives who have been around for a couple of decades were trained in a product-centric world. Second, a company's focus changes over time. During the entrepreneurial phase, the company must focus intensely on the customers or it will fail. As the company grows and succeeds, however, it tends to become focused more and more on itself — its internal budgets, internal resource concerns and internal politics — and therefore has a great deal of difficulty with customer-centric thinking.

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The authors: Adrian J. Slywotzky is a director at Oliver Wyman, as well as the author of a number of books, including *Value Migration*. David J. Morrison is a graduate of the U.S. Naval Academy and holds an engineering degree from Princeton and an M.B.A. from Harvard Business School. The authors' previous collaborations are *Profit Patterns* and *How Digital Is Your Business?*

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Summary: THE PROFIT ZONE

Customer-Centric Business Design

(continued from page 2)

Reverse the Value Chain

To begin customer-centric thinking, managers must reverse the traditional value chain. Customer-centric thinking focuses on the customers' needs and priorities and identifies options through which these needs and priorities can best be met.

From there, it is determined what channels can satisfy those needs and priorities, the service and products best suited to flow through those channels, the inputs and raw materials required to create the products and services, and the assets and core competencies essential to the inputs and raw materials. In other words, the traditional value chain must be completely reversed.

Cracking the Code on Customer Priorities and Systems Economics

Customer priorities are the things that are so important that the customer will pay a premium for them or, when they can't get them, will switch suppliers. With an industrial customer, there is rarely one buyer or one source of influence. The structure of a customer's needs, behavior, decision-making process, price sensitivities and preferences is as complex as any molecule. The challenge in strategic customer analysis is to both understand multiple levels within an organization and be able to use various methodologies to put together a mosaic of the real picture.

Even putting the right questions to the right people will not always provide a manager with enough information, because not all of a customer's needs are articulated. One of the most powerful tools for ferreting out those silent, unarticulated and at times unknown priorities is analysis of the customer's systems economics.

A customer's systems economics includes the amount paid for the product or service; the costs to use, store and dispose of it; the time consumed in the purchase transaction and the usage pattern; and the amount of

hassle that has to be tolerated or paid out throughout the entire process.

Really knowing the customer's systems economics enables you to answer this question: "How can we really add value to the customer?" The answer to that question can be ascertained by creating a privileged information flow from a truly market-representative cross section of customers. If you aren't meeting true customer priorities, you run the risk of supplying an irrelevant product to indifferent customers.

Anticipate Changing Priorities

The key question for customer-centric business design is not what a customer's priorities are today — that game is already over — but what a customer's priorities will be tomorrow. The odds of discovering that rise dramatically when three things happen:

1. The information comes from relevant sources at multiple levels of the customer's organization.
2. The questions asked are nonstandard, creative and challenging.
3. There is a balance between understanding the next opportunity and recognizing the financial, political, accounting and organizational barriers that stand in the way of capturing it.

Build the Next Business Design

Equipped with an understanding of what your customer's priorities will be tomorrow, you can begin the process of building your company's next business design. The first question in customer-centric business design will not be about core competency but about customer relevance.

The offering will change from products (which are abundant) to solutions (which are difficult to create). The company's activities will change from "Do everything" or "Do what we do well" to "Do what matters to the customer" and "Do what we are best at." Outsource the rest, or find business partners to provide it with you.

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The Value Chain

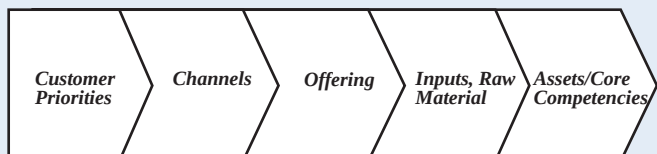
The Traditional Value Chain

Start with Assets, Core Competencies



The Modern Value Chain

Start with the Customer



Customer-Centric Business Design

(continued from page 3)

The key driver will be customer relevance rather than a focus on what a company knows how to do. ■

How Profit Happens

Profitability is an extraordinarily complex phenomenon. How and why profitability occurs varies significantly from one industry or company to another. There are at least 22 models/patterns of profitability that explain how profit happens in various businesses. More will be discovered. And, in certain businesses, the interplay of two or more of these models explains how profit really happens in the business.

Profit-Centric Business Design

In the classic product-centric age, the key question was, “How can I gain market share, increase unit volume and gain scale economies?” In the new age of rapidly shifting market value that commenced in the mid to late 1980s, the questions are different: “Where will I be allowed to make a profit in this industry?” and “How should I design my business model so that it will be profitable?”

Eleven profitability models are described here. Each model has different business patterns and strategies that you can use to move your company into the profit zone.

1. Customer Development/Customer Solutions

Profit: Companies that implement a customer development model invest heavily to understand their customers’ economics and find ways to make them more favorable. They reach the profit zone by first probing how their customers buy and use their products and then finding ways — beyond merely selling the products — to help the customers in the difficult, expensive or time-consuming areas of their process. The method by which customers are developed explains the companies’ profitability.

Successful firms that have applied the discipline of the customer development model include Nordstrom, Intuit and Northwestern Life. Each has achieved significantly higher customer continuity than its competitors and, as a result, higher levels of sustained profitability.

2. Product Pyramid Profit: The variations in customer income and preferences make it possible to build product pyramids. They exist in markets as diverse as watchmaking, automotive sales and credit cards. At the base are low-priced, high-volume products. At the apex are high-priced, low-volume products.

The profit is concentrated at the top of the product pyramid, but the base of each pyramid plays a critical

strategic role in the system. Astute business designers such as Mattel make certain to build a “firewall” brand at the bottom of the pyramid: a strong, low-priced brand that is produced at a profit, however slim. The purpose of this brand is to deter competitor entry, thereby protecting the enormous profit margins at the top of the pyramid.

For example, Mattel produces a low-end Barbie doll so that (1) no uncontested space is left open for competitors and (2) profits from the \$200 special-edition Barbie doll at the top of the product pyramid are protected. When a firewall brand isn’t built, competitors have the opportunity to come in at the bottom and then work their way toward the top, where the profits are.

3. Multicomponent System Profit: In some businesses, there are several components of the production and selling system and each component has radically different profit characteristics. Failure to maximize participation in the highest-profit components depresses the profitability of the entire system. On the other hand, full participation in the less profitable components is required to win the market for the most profitable components.

In carbonated beverages, for example, the components are grocery, fountain and vending. Price realizations are: grocery, 2 cents per ounce; fountain, 4 cents per ounce; and vending, 6 cents per ounce. The profit zone is in fountain and vending, but in order to win in those areas, a company needs a strong brand. Brands are developed and maintained through the mass-market, low-profit grocery segment. One fights to maintain share and brand position in low-margin grocery; one maximizes vending penetration to maximize profitability. Coca-Cola learned and applied this brilliantly.

4. Switchboard Profit: Some markets are characterized by multiple sellers communicating to multiple buyers. High transaction costs are incurred by both. There may be an opportunity to create a high-value intermediary that concentrates these multiple communication pathways through one channel, by creating a “switchboard.” This reduces the costs of both buyers and sellers, in exchange for a fee to the switchboard operator. Examples include Schwab’s OneSource and Autobytel.

5. Time Profit: In business, speed is usually important. Often, a first-mover advantage allows an innovator to generate excess returns before imitators begin to erode margins. The time profit model is designed to take advantage of this phenomenon. In this model, profit derives from uniqueness. Price premiums exist, but only until imitation erases them.

The reality of this pattern is that prices are high and

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Summary: THE PROFIT ZONE

How Profit Happens

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profits are abundant — there is a profit zone — but only for a short period of time. Constant innovation is the only way to remain in the profit zone. As value migrates away from its most recent innovation, a company must introduce the next one, in order to re-enter the profit zone. This profit model is at the core of Intel's success, which is why the entire Intel business design is geared for speed.

6. Blockbuster Profit: Understanding blockbuster profit is essential for pharmaceutical companies, publishers, film studios, music companies and software firms, which have large R&D and launch costs and finite product cycles.

When the cost to develop a new product is fixed (and usually high) and marginal costs of manufacturing after development are low, the best way to maximize profits is to improve the chances that the product will achieve very high volume levels. With these economics, it is better to be the dominant leader in a few products than to support average positions in many products.

7. Profit Multiplier Model: A profit multiplier model reaps gains, continually, from the same product, character, trademark, capability, or service. Profit multiplier models can be powerful engines for businesses that have strong consumer brands. Once the huge investment in creating a brand has been made, the creator may give the brand license across a broad array of products.

The best example of a profit multiplier is Disney. Mickey, Minnie, Hercules et al. appear in movies, videos and books; on clothes, watches and lunch boxes; at theme parks; and in stores. No matter what form they take, these characters are generating returns for Disney.

8. Entrepreneurial Profit: Some determinants of profitability are organizational rather than economic. As organizations succeed and grow, they become more formalized, more bureaucratic, more careful, more remote from customers and slower to act. Diseconomies of scale begin to work, overhead grows and decision making slows. Direct feedback from customers is reduced, filtered and often ignored.

The company is vulnerable to entrepreneurs who are in direct contact with customers or proactively solicit feedback and who remain frugal because they have no cushion of affordability to support unnecessary expenses. These twin forces of direct customer contact and extreme frugality create the potential for enormous profitability. Most large companies, however, do not have a business design that permits them to harness these twin

forces of the entrepreneurial condition.

The most determined application of the entrepreneurial profit model is Thermo Electron, which pre-empts the profit-destroying effects of size by constantly spinning out new companies. It's hard to compete against the entrepreneurial profit model. It's easier to compete against a larger, slower, more insulated player.

9. Specialization Profit: All businesses start off being very good at something. They begin by offering a specialist's expertise. But as they grow, they often move beyond their specialization. They take on more and more activities at which they are mediocre. Revenues grow; profitability declines.

On the other hand, growth through *sequenced* specialization can be extraordinarily profitable. Electronic Data Systems (EDS), for example, grew through sequenced specialization — mastering the intricacies and economics of computer solutions for many vertical segments (health care, insurance, manufacturing, banking), but doing so sequentially, not simultaneously. In each vertical segment, EDS establishes expertise that is unmatched — it becomes a specialist — and it rolls that expertise across the entire segment. Then it moves on to another segment.

10. Installed Base Profit: One of the most powerful profit mechanisms in business is the installed base profit model. The supplier creates an extensive installed base of users, who then buy the supplier's brand of consumables or follow-on products. The installed base profit model can be extremely lucrative — if the follow-on market can be controlled.

This was a key component of Bill Gates' thinking, from his very first business move. Microsoft's strategy was to price low, set the standard, achieve ubiquity and then harvest the profits from upgrade/revenue.

11. DeFacto Standard Profit: The installed base becomes a critical element of another high-profit model when it allows the owner to establish a de facto standard. The standard then drives customer and competitive behavior for an entire industry. In this type of business, numerous players, from original equipment manufacturers (OEMs) to applications developers to users, are drawn into the gravitational orbit of the standard holder.

The more players that enter the system, the more valuable the system becomes. As a consequence, the holder of the standard can experience increasing returns as the value of the system grows. Microsoft has been able to convert its installed base position into a de facto standard that is a very powerful economic engine.

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Summary: THE PROFIT ZONE

How Profit Happens

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Protecting Your Profitability

While a company is developing a powerful business design to generate profit growth, it must simultaneously search for and develop the strategic control points in its industry. The purpose of a strategic control point is to protect the profit stream against the corrosive effects of competition and customer power. The rapid growth of customer power in the past two decades has forced strategic control to the top of the priority list.

There are many types of strategic control points: brand, patent, copyright, two-year product development lead, 20 percent cost advantage, control of distribution, control of supply, owning customer information flow, a unique organizational culture and value chain control. Each control point is designed to keep a company in the profit zone and to prevent competitors from stealing away that profitability.

Every good business design has at least one strategic control point. The best business designs have two or more. Intel, for example, has a two-year lead, value chain control and a brand. Coca-Cola has a brand, a low-cost logistics system, value chain management and a string of superdominant positions (a market share that is three, four or five times its competitors' share) around the world.

GE has a low-cost position and owns the customer relationship in the many cases where it provides a full package of services and solutions to its customers. Disney owns the customer relationship in family vacations, plus a set of copyrights and a unique organizational culture that competitors have yet to duplicate. Microsoft owns the standard, a string of superdominant positions (in multiple product categories) and a brand. ■

Some of the Reinventors and How They Succeeded

Over the past couple of decades, several business leaders have emerged who have figured out, or intuitively understood, how the rules of the game have changed. Their record of value growth is all the more remarkable when compared to the growth prospects of their industries and the lagging value performance of the market share leaders.

These reinventors think, see and act differently. They start with the customer and work their way back. They are constantly focused on how the profit zone is shifting. A decade ahead of their peers, the reinventors saw the move from the old product-centric, market share world to

the new customer-centric and profit-centric environment.

The old-order companies concentrated on market share and yesterday's profit zone. The new-order companies reinvented their business design every five years to stay relevant to customers and to move into new profit zones. Several hundred billions of dollars of value shifted from companies that had dominated yesterday's profit zone to those that were finding or creating the profit zones of tomorrow.

Jack Welch — GE

GE's business design answers the manufacturer's primary question: "How can I make a profit by making and selling my product?" Most manufacturing companies only create value for customers with their products — they all have product-centric business designs. In this environment, the only way a company can distinguish itself is by establishing itself as a cost or quality leader. And if all players within an industry pursue cost and quality leadership, the industry becomes a no-profit zone.

As CEO of General Electric, Jack Welch reinvented GE's business design three times, each time moving further away from the product-centric manufacturing model. His most recent design is referred to as "Solutions Selling" — a response to the needs and priorities of GE's customers.

A mid-size company bought \$500,000 worth of personal computers from General Electric. What makes this news? Well, for starters, GE doesn't make computers! The firm didn't buy its computers directly from the manufacturer because the manufacturer only sells computers — a commodity product available from dozens of sources.

In contrast, GE sold the company the computers — plus much more. GE saw this company's set of needs and met them. It provided a solution. The profit zone for GE was not found in the product (the computer); it was found in the solution (add-on options, accessories, service contracts and financing).

Jim Donahugh — Madden Communications

Reinvention is not just for the giants of industry, CEOs of large public companies, nor just for senior managers. The principles and techniques of reinventing a company's business design to get it into the industry's profit zone are available to all of us.

Jim Donahugh was hired as a salesman by Madden Graphics, a commercial printing company, in 1975. He exercised persistent customer-centric thinking by asking such questions as "What can I do to add real value to a customer?" and "What would be more valuable than just

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Summary: THE PROFIT ZONE

Some of the Reinventors and How They Succeeded

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selling the customer a printing job?” Donahugh followed his instincts all the way to the presidency of his company.

Madden Graphics eventually became Madden Communications. Donahugh changed Madden’s printing company business model to that of a communications management company, which integrates display construction design, manufacturing, assembly and distribution of point-of-sale materials. Madden’s core activity is still printing, but the Madden people don’t really *care* about printing as an end in itself. They care about what it does for their customers.

Nicholas G. Hayek — The Swatch

Sometimes, the reinvention of a company starts with reinventing an entire industry. That was the task that Nicholas Hayek, a Swiss engineer and the entrepreneur behind the Swatch watch, set for himself. His approach was to emotionalize his product, build a product pyramid from low price point to high and build a firewall brand to protect the profits in his product pyramid system.

The Swiss watch industry, leading the world market for decades, was essentially destroyed in the 1970s by new business designs from Timex, Citizen, Seiko and Casio. It became a no-profit zone.

Hayek’s key move in the 1980s was to cross the threshold defining “economy timepiece” and move into an economic neighborhood defined as “accessory,” “style” and “fashion statement.” This was a world of design and fashion, not craftsmanship. He was interpreting the 18- to 30-year-old consumer who was buying Nike athletic shoes, Benetton sweaters and Gap apparel.

In the face of enormous skepticism, Hayek decided to make a plastic watch that could be manufactured inexpensively in Switzerland, with fewer moving parts and less frequent repairs. He combined the words “Swiss watch” to make “Swatch” and introduced a product that challenged all the traditions of the industry.

Hayek made Swatch his firewall brand at the bottom of the product pyramid, which secured the low-end market and made it profitable. Then he protected and expanded his positions in the upper part of the pyramid, taking advantage of the profit zone in mid- and high-level watches, selling for 1 million Swiss francs or more.

Charles Schwab

Charles Schwab revolutionized the financial services industry by asking the right questions. By always looking

Roberto Goizueta — Coca-Cola

As Coca-Cola’s new CEO in the early 1980s, Roberto Goizueta inherited a Coke that was powerless to manage the profitability of its own system. In the beverage industry, the value chain consists of syrup manufacturing, bottling, logistics, distribution, marketing and consumer relations. Moving from syrup maker and advertiser (Coke’s business design in 1980) to value chain manager (Coke’s business design in 1997 and beyond) helped Coca-Cola capture the most profitable zones of the beverage industry.

Goizueta’s most significant business design innovations were managing the value chain and focusing investment on the high-profit zones. He regained control of profit opportunities by redefining who his customers were.

forward and asking how customers’ priorities are shifting, Schwab has remained two steps ahead of the industry.

There was only one kind of player in the investment game of the early 1970s — the full-service broker. A traditional brokerage house commanded high fees because it provided investors with a “bundled package” — advice and counsel along with trading capabilities. There was no option for investors who only wanted access to low-cost trades.

Schwab’s first new business design was the discount brokerage, which allowed an investor, acting on his own ideas and without advice, to execute trades at a lower price.

Then, when independent, fee-based investment advisory services started to grow in popularity in the 1980s, Schwab saw a new set of customer priorities. Investors were going to independent investment advisors, or “financial planners” because they needed and wanted advice unvarnished by the broker commission structure. Recognizing these advisors as potential allies and bridges to new customers, Schwab expanded his business design to treat financial planners as his customers and developed new services for them.

Finally, during the 1990s, Schwab redesigned his business once again. He noticed the soaring popularity of mutual funds among investors and observed that the way they were being bought and sold was inefficient and expensive. It was expensive for the mutual fund companies to market broadly, and it was expensive and time-consuming for a customer to simultaneously deal with several mutual funds. Schwab established a “switchboard” between them, making it less costly for mutual funds to reach customers and less complicated

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Summary: THE PROFIT ZONE

Some of the Reinventors and How They Succeeded

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for the customers who could now deal with several mutual funds through one point of contact. This new innovation was called the Schwab OneSource.

Schwab was responding to both profit-centric and customer-centric questions. He redesigned his business to meet investors' needs for less record-keeping hassle and lower transaction costs. At the same time, he made the mutual fund companies into Schwab customers by charging them for access to the Schwab investor base. ■

Other Reinventors

Reinvention can be found in almost any industry and can be bolstered by a variety of business designs.

- **Andrew Grove of Intel used the “Two Steps Ahead” business design.** In an industry that has seen enormous growth and innovation, he managed to stay in the profit zone by managing more of the industry's value chain and by owning the relationship with the end user.

- **Michael Eisner of Disney used the “Profit Multiplier” business design.** He saw that Disney was becoming more and more an intellectual property business. He expanded Disney's audience from children to the entire family. He also expanded Disney's scope from movies, theme parks and licensed consumer products, to television production, TV and radio network broadcasting, cable networks, videocassettes, DVDs, retail stores, theme park hotels, vacation packages, sports teams, Broadway musicals, cruises and much more.

- **George Hatsopoulos of Thermo Electron used the “Spin-Out” or “Entrepreneurial” business design.** Believing that the size of the company hindered its ability to stay one step ahead of the customer — and the need to continually motivate and retain his most talented employees — as the company grew, Hatsopoulos implemented a plan to spin out its core businesses into separate semi-independent companies. Led by key talented employees who were rewarded based on performance, Thermo Electron was able to intensify the company's contact with customers, gain better profit results and more easily attract capital investment. ■

The Profit Zone Handbook

Perhaps the single most striking observation about the reinventors' achievements in business design is how different they are — different from each other and different from their peers. The success logic that drives Coke's

business design is completely different from the logic that drives GE's. Microsoft and Disney are worlds apart.

Reinvention is about the customer and profitability, but ultimately it is about creativity — about designing a business model that is unique.

Perhaps the most important benefit of studying reinventors and how they discover or create profit zones in their industries is grasping how the creative process works in business (how business designs change every five years), what discipline (in customer and profit thinking) it requires and how extraordinary its outcomes can be.

Moving Your Company Into the Profit Zone

The process of moving your company into the profit zone involves addressing a sequence of 12 questions:

1. Who are my customers?
2. How are their priorities changing?
3. Who *should* be my customer?
4. How can I add value to the customer?
5. How can I become the customer's first choice?
6. What is my profit model?
7. What is my current business design?
8. Who are my *real* competitors?
9. What is my toughest competitors' business design?
10. What is my next business design?
11. What is my strategic control point?
12. What is my company worth?

By answering these questions, you will be equipped to beat your competitors to the profit zone.

Each of the reinventors previously mentioned has been extraordinarily successful at using carefully chosen tactics to create exceptional profit growth for his company. These are also tactics that can be used by anyone at any level in any business. By using these techniques, you will be able to create value for your customers and capture value for your business. You will be able to move your company into the profit zone. ■



If you liked *The Profit Zone*, you'll also like:

1. ***Exceeding Customer Expectations* by Kirk Kazanjian.** Kazanjian provides a thorough case study of the success of Enterprise Rent-A-Car and offers an in-depth look into the practices that have boosted the company to the top of its industry.
2. ***Know-How* by Ram Charan.** The author presents eight skills that separate top performers from nonperformers in the corporate world.
3. ***Blueprint to a Billion* by David G. Thomson.** This is a valuable guide to the seven essentials that top companies need in order to achieve exponential growth.

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39-18 Profit First

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Profit First

Transform Your Business from a Cash-Eating Monster to a Money-Making Machine

THE SUMMARY IN BRIEF

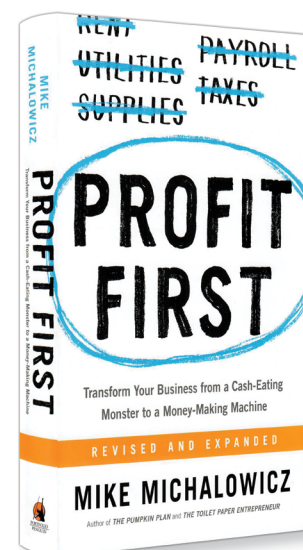
What if, rather than you serving your business, your business served you? What if you could turn a profit from your very next deposit? And what if you had the power to guarantee that profitability?

It's possible, and the solution is simpler than you think. Mike Michalowicz, the author of perennial bestsellers *The Pumpkin Plan*, *The Toilet Paper Entrepreneur* and *Surge*, has developed a counterintuitive cash-management system that has helped tens of thousands of small businesses break out of the doom spiral and achieve instant profitability. Now, you can do it too.

Treating profit like an afterthought, secondary to growth, usually has the effect of running your business into the ground. *Profit First* takes a behavioral approach to accounting and flips the formula: **Sales - Profit = Expenses**. Just as one of the most effective weight-loss strategies is to limit portions by using smaller plates, Michalowicz shows how to take profit first and spend only what remains on expenses. With this one change, you will instantly transform your business from a cash-eating monster to a profitable cash cow.

IN THIS SUMMARY, YOU WILL LEARN:

- Why following four principles can simplify accounting and make it far easier to manage a profitable business by just looking at bank account balances.
- How taking your profit first both enforces frugality and inspires industry-changing innovation.
- That a small, consistently profitable business can be worth much more than a large business that struggles to sustain itself.



by Mike Michalowicz

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THE COMPLETE SUMMARY: PROFIT FIRST

by Mike Michalowicz

The author: Mike Michalowicz launched and sold two multimillion-dollar companies and is the co-founder of Profit First Professionals, a membership organization of accountants, bookkeepers and coaches who teach the Profit First method. He is a former columnist for The Wall Street Journal, and is a popular keynote speaker who has shared his insights on business and entrepreneurship at TEDx, creativeLIVE, INCmty and others. He is the author of *The Pumpkin Plan*, *Surge* and *The Toilet Paper Entrepreneur*.

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Your Business Is an Out-of-Control Cash-Eating Monster

No matter how many years you've been at the grind, you are probably well aware of the statistic that roughly 50 percent of businesses fail within the first five years. What they don't tell you is that those failed entrepreneurs are, in fact, the lucky ones! The majority of businesses that survive are racking up debt, and their leaders are perpetually stressed. Most entrepreneurs are living a financial nightmare.

Stitching together a business with nothing but a great idea, your unique talents and whatever few resources you have at hand is a miracle. And it feels like one, too, until the day you realize your business has become a giant, scary, soul-sucking, cash-eating monster.

No amount of talent, ingenuity, passion or skill will change the fact that cash is still king. Master the essence of financial security: Save your money and block access to it so it doesn't get stolen — by you.

Bigger Is Not Better

Growth is the battle cry of nearly every entrepreneur and business leader. But growth is only half the equation. Most business owners try to grow their way out of their problems by hinging salvation on the next big sale or customer or investor, but the result is simply a bigger monster.

Entrepreneurs assume that at a certain point, their revenue will yield a profit. Profit is always within sight but never attainable. What they don't realize is: Profit is not an event. Profit is a habit. ●

The Core Principles of Profit First

Quick fixes for weight loss don't work and aren't sustainable. What we really need are simple *lifestyle* fixes that change how we eat without our even really noticing. For example, use smaller plates.

If you reduce the "plate size" of your business's operating account, you will spend differently. So rather than curb your spending habit, create the experience of having less cash on hand than you actually have and then find ways to still make things work.

The Four Core Principles of Profit First

- 1. Parkinson's Law.** In 1955, a modern philosopher named C. Northcote Parkinson came up with the counterintuitive Parkinson's Law: The demand for something expands to match its supply. In economics, this is called induced demand. The more we have of something, the more we consume. You need to intentionally make less money available to operate your business. When there is less, you will automatically run your business more frugally, and you will run your business far more innovatively.
- 2. The Primacy Effect.** We place additional significance on whatever we encounter first. When we follow the conventional formula of Sales - Expenses = Profit, we are primed to focus on those first two words, *Sales* and *Expenses*, and treat *Profit* as an afterthought. We then behave accordingly. We sell as hard as we can, then use the money we collect to pay expenses. We stay stuck in the cycle of selling



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to pay bills, over and over again, wondering why we never see any profit. When profit comes first, it is the focus, and it is never forgotten.

3. **Remove Temptation.** As you implement Profit First, you are going to use the powerful force of “out of sight, out of mind.” As you generate a profit, you are going to remove the money from your immediate access. You won’t see it, so you won’t access it. And just like anything that you don’t have a reasonable degree of access to, you will find a way to work with what you do have and not worry about what you don’t.
4. **Enforce a Rhythm.** When we get into a rhythm, we don’t get into the reactive mode of crazy spending when we get big deposits and panicking in the face of big cash dips. Establishing a rhythm will get you out of the daily panic. In fact, establishing a rhythm will also be a great indicator of overall cash flow. Instead of reading the cash flow statement, you can measure your cash flow by just checking your bank accounts.

But If I Set Aside My Profits, How Will I Grow?

The fastest, healthiest growth comes from businesses that prioritize profit. And it is not because they plow money back into their businesses. Businesses that plow back their profits aren’t truly profitable; they are just holding money temporarily (feigning profit) then spending it, just like any other expense.

Taking profit first will help you figure out which of the many things you do makes money and which don’t. Then the direction is obvious — you do more of what is profitable, and you fix (or dump) what is not. You will focus on what makes profit for you, and you will get better and better at it. And when you get better at what your customers already want and like, they will like you more. All this translates into fast, healthy growth.

The New Accounting Formula

The next step is to put a system around the normal you. And we start with a simple, new Profit First formula:

Sales - **Profit** = Expenses

Here’s how you apply the four principles:

1. **Use Small Plates.** When money comes into your main INCOME account, it simply acts as a serving tray for the other accounts. You then periodically disperse all the money from the INCOME account into different accounts in predetermined percentages.
2. **Serve Sequentially.** Always, *always* allocate money based on the percentages to the accounts first. Never, ever, ever pay bills first. The money moves from the INCOME account to your PROFIT account, OWNER’S COMP, TAX and OPERATING EXPENSES (OPEX). Then, you pay bills only with what is available in the OPEX account. No exceptions. And if there isn’t enough money left for expenses? This does not mean you need to pull from other accounts. It means that you can’t afford those expenses and need to get rid of them.
3. **Remove Temptation.** Move your PROFIT account and other tempting accounts out of arm’s reach. Make it really hard and painful to get to that money, thereby removing the temptation to “borrow” from yourself. Use an accountability mechanism to prevent access except for the right reason.
4. **Enforce a Rhythm.** Do your allocations and payables twice a month (specifically, on the 10th and 25th). Don’t pay only when there is money piled up in the account. Get into a rhythm so that you can see how cash accumulates and where the money really goes. This is controlled by recurring and frequent cash-flow management, not by-the-seat-of-your-pants cash management. ●

Setting Up Profit First for Your Business

The Five Foundational Accounts

It’s time to take your first step: setting up your accounts. Here are the five checking accounts you need to set up:

1. INCOME
2. PROFIT
3. OWNER’S COMP
4. TAX
5. OPEX

Make sure you set these up as checking accounts, and name your accounts according to their purposes.

You can use your existing primary bank account as one of the five accounts. Rename it your OPEX account

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because you are likely paying all your bills from that account. Going forward, move deposits to your INCOME account. This includes check deposits, credit card or Automated Clearing House (ACH) payments. Update your bank information as necessary.

Two “No-Temptation” Accounts

Your next step is to set up two “no-temptation accounts.” Get your taxes out of sight and out of mind. Do the same with your PROFIT account.

Find a new bank that you have never worked with before. At the second bank, set up two savings accounts: PROFIT HOLD and TAX HOLD. Then link these two accounts to the respective PROFIT and TAX accounts at your primary bank so that you are able to transfer money.

Picking the Bank

At your primary bank, you want easy access to view your accounts, easy ability to transfer money from INCOME to your other accounts, and you want to be able to pay bills out of OPEX. At your secondary bank, you want no convenience options. Remember: out of sight, out of mind.

Some (but very few) large banks will work with you by cutting out the fees. But, many regional and local banks and federal credit unions will be thrilled to work with you, and in many cases, they don't have all those fees in the first place.

If you like your current bank, tell them that their requirements for a minimum balance and transfer fees don't work for you. Ask to waive the minimum balance requirement and other fees. If your bank complies, kudos to you. If not, move on to a new bank. ●

Allocation Percentages

Some entrepreneurs try to kick-start their Profit First system by taking a profit of 20 percent immediately. This is a classic mistake. However, there is a way to reach your goal.

The Target Allocations Percentages (TAPs) are simply the targets you are moving toward. TAPs are not your starting point. Aspire to move toward the TAPs, which can range from 5 percent to 20 percent depending on the size of your business revenues.

The Current Allocation Percentage (CAP) is where your business is today. This is the number you will adjust slowly but consistently over time to get closer and closer to the TAPs. For example, the Profit TAPs for your business size might be 20 percent, but your historical

profit allocations might have been 0 percent. If you haven't made profit allocations until now, then your profit CAP is 0 percent.

Perhaps you will never quite reach the TAPs to which you aspire. But they will force you to constantly think about what you are doing and how you are doing so that you can get closer.

Owner's Comp TAP

Owner's compensation is the amount you and the other equity owners take in pay for the work you do. Your salary should be on par with the going rate for the work you do, in other words, the salary you would have to pay your replacement.

Take a realistic look at the work you do. If you have a small company, you may call yourself the CEO, but that's just the title on your card. It's likely you are doing a lot of other work. In reality, about 2 percent of your time is doing the job of CEO: vision planning, strategic negotiations, acquisitions, reporting to investors, addressing the media, etc. Determine your salary based on what you are doing 80 percent of the time and what you would reasonably pay employees to do those jobs. Then, evaluate pay for all equity owners who work in the business.

Add up the salaries that represent your Owner's Comp draw. The percentage of revenue you set as your Owner's Comp TAP must, at a minimum, cover Owner's Comp draw. Make the percentage one and one-quarter times the amount you determine for your salaries, so you can adjust for revenue fluctuations, and be able to cover raises and bonuses.

Your Tax TAP

The first step in getting to your Tax TAP is to determine your income-tax rate. One goal of the Profit First system is that the company takes care of all forms of Tax responsibility. It's mandatory that you talk with your accountant so she can advise you on all the ways you and your business will be taxed.

Here are three different approaches for determining your Tax TAP:

1. Look at your personal and business tax returns Add up your taxes then determine the percentage of taxes you paid compared with your Real Revenue (Real Revenue = Top Line Revenue - Materials and Subcontractors). Do this again for the previous two years. Looking at your taxes as a percentage of Real Revenue for the last three years will give you a good sense of your ongoing tax responsibility.

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2. From your accountant, get your estimated tax responsibility for your business, year to date (YTD), and then determine your Tax percentage of your YTD Real Revenue.
3. Or, simply use 35 percent for U.S.-based businesses, and if you have a business in another country, use the average prevailing rate of taxes for an individual at your income rate as your tax number. ●

Putting Profit First Into Motion

Day One

1. **Tell your people.** Include your financial professionals in the implementation of Profit First right from the start. Pull the numbers and then, with your bookkeeper and accountant, do a projection for the year. Then, work in the PROFIT account percentage you want to start with. With buy-in from your accountant on the principles and processes of Profit First, you can systematically apply the method to your business. Your accountant will help you meet your Profit First goals and stay the course.
2. **Set up your accounts.** If you haven't already, set up your foundational five accounts at your primary bank (INCOME, PROFIT, OWNER'S COMP, TAX and OPEX) and the two accounts at your new no-temptation bank (PROFIT HOLD and TAX HOLD). Do *not*, repeat, *do not*, try to make a shortcut and just do this in a spreadsheet or in your accounting system. And absolutely do not try to do all of this in your head.

Now, you are going to add to the nickname for each account by adding the CAP next to the account name and also putting your TAP in parentheses. For example, if you are nicknaming your PROFIT account, and the CAP is 8 percent and the TAP is 15 percent, nickname the account "PROFIT 8% (TAP 15%)." This allows you to quickly identify what money is going where, and the ultimate allocation percentage you are trying to achieve. At this point, we have determined the TAPs for each account. But TAPs are simply the vision. TAPs are not where we start.

For your CAPs, we'll start at our Day Zero contribution levels (the historical percentages you were allocating to each category before implementing Profit First) for each account and then add 1 percent, which brings us to Day One of your Profit First implementation. If your business has never had a profit or if you sometimes had a profit

and sometimes a loss, your profit has been zero. Therefore, our easy Day One start for the PROFIT account will be 1 percent CAP, and we will bump it up as we start getting into our quarterly rhythm.

Continue to add 1 percent to your Day Zero Tax allocation and Owner Compensation allocation to create new CAPs. Even if your targets are much higher, start with what you've got plus 1 percent for Profit, Owner's Comp, and Tax. Then, reduce the Operating Expenses by the cumulative of the percentage adjustments you made to the other three accounts.

Why start with small percentages when you likely could do more? The primary goal here is to establish a new, automatic routine. The goal is to set up these automatic allocations immediately and then adjust the percentages each quarter until you are aligned with your target distribution percentages.

3. **Make your first distributions.** Look at your bank balance in your original primary account, which we have renamed your OPEX account. Then, subtract any outstanding checks and payments you have from that account. Transfer the remainder of the money into your INCOME account. Now, divide up the money in the INCOME account into all the other accounts based on the CAPs you set. You will see that a huge portion of your money is going to expenses. Over time, you will be motivated to reduce expenses, and perhaps even more importantly, you will find ways to increase your profitability via innovation.

Week One: Cut Expenses

Now that you are moving money into your PROFIT, OWNER'S COMP, TAX and OPEX accounts, you need to get the money from somewhere. There are only two ways to do that: increase sales and cut expenses. Increasing sales is doable, but it takes time. Cutting expenses is generally a very quick and easy process. Most businesses find it easy to cut 10 to 20 percent of expenses overnight, such as frivolous costs like unused, recurring membership fees, office space that impresses no one, an expensive car or perhaps even extra staff who aren't helping your cause much.

You have just accounted for at least 3 percent (1 percent in each of the PROFIT, OWNER'S COMP and TAX accounts) of your income, so you need to cover that by cutting 3 percent of your expenses. To do that, print out your expenses for the last 12 months and any recurring expense, such as rent, subscriptions, internet access, training classes, magazines, etc.

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Now, add up all the expenses and multiply that number by 10 percent. You must cut costs by 10 percent.

Why 10 percent when we only need 3 percent? Because it may take a month or two to pay down balances owed on the expenses you eliminate. More importantly, you need to start building cash reserves because by the start of the next quarter, you are going to move another 3 percent to your PROFIT, OWNER'S COMP and TAX accounts and then another 3 percent the quarter after that.

You can easily find your first 10 percent in cuts by doing the following:

1. Cancel whatever you don't need to help your business run efficiently and keep your customers happy.
2. Negotiate every remaining expense except payroll.

Twice a Month: The 10th and the 25th

By looking at your bills and deposits two times a month, on the same days each time, you can see a pattern. You'll see trends and understand your cash flow.

Here's how to get started:

Step One: Deposit all revenue into your INCOME account.

Step Two: Every 10th and 25th day of the month, transfer the total deposits from the previous two weeks to each of your five allocation accounts based on your CAPs.

Step Three: Transfer the full account balances for both your TAX and PROFIT accounts to the respective accounts at your second (no-temptation) bank.

Step Four: Take from your OWNER'S COMP account only what you have allocated as your biweekly salary and leave the rest to accumulate.

Step Five: Pay your bills with the money remaining in the OPEX account.

Note: There is a possibility that you will not have enough money in your accounts to pay bills or pay yourself. This should be a major wake up call. It is your business shouting out that you can't run your business the way you have been running it. You are spending more money than your business can support.

Quarter One

You are going to take a profit-distribution check every quarter. Don't confuse the profit distribution with Owner's Comp, which is pay for working in the business. Profit is a reward for owning the business.

Every quarter you will take 50 percent of what is in the account and leave the other 50 percent alone. If your company has multiple owners, the distributed profit is divided up based on the percentage owned by each equity owner.

The key is this: the profit distribution can never go back to the company. Your business needs to run off the money it generates in its operating expenses. So, always take your profit, every quarter, and use it for your own purposes.

Pay Uncle Sam. Every quarter, you will also pay your quarterly tax estimates.

One Small Step. Each quarter, you need to evaluate your current percentages and move them closer to your TAPs. You can move any percentage you want to get to your TAPs, but the goal is to never take a step back.

If you are adjusting and tweaking your percentages conservatively, it is suggested that you account for 3 percentage points each quarter. Meaning you could move your PROFIT account from 5 percent to 8 percent. Or you could move your TAX, PROFIT and OWNER'S COMP accounts up 1 percent each. And if you can adjust more, go for it.

Year One

Because you're in the quarterly rhythm of evaluating and moving closer to your TAPs, there isn't much of anything special you need to do on a yearly basis. The only thing you need to add to your financial management at year-end is the finalization of your taxes.

Determine how much you owe. If you owe more than you have in your TAX account, a few things likely went wrong. You didn't save a big enough percentage, or you didn't check in quarterly with your accountant to see how you were doing with your tax reserve.

If you owe taxes at year-end and don't have the money in your TAX account, this is the one time you can pull from your PROFIT account for a reason other than profit distribution. Adjust percentages in your TAX account to ensure you will have enough for the next year. ●

Destroy Your Debt

Even when you and your business are in debt, you must establish a habit of putting your profit first. When you get into a habit of fiscal health, you will fix the problem permanently.

The Profit First system's approach to dealing with debt is this: When you distribute profits, 99 percent of the money goes to paying down debt. The remaining 1 percent goes toward rewarding yourself.

Preparing for Your Worst Month

The trap entrepreneurs fall into is believing their most recent best month is their new normal. To prevent

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shortsighted behavior but stay optimistic, always look at your 12-month, rolling average income and related numbers. When comparing figures, compare your current month to the same month in the previous year.

Until your best month becomes your average month, it's not the norm; it's the exception. When you base decisions on your best revenue month, you will run out of cash — quickly. Debt will start to pile up.

The Debt Freeze

The following will guide your business through a rapid pay-down of accumulated debt and a freeze of new debt all while continuing your Profit First habit.

Print and Mark Up Documents

1. Print out your current income statement for the last 12 months as well as your current accounts payable report, your credit card statements, loan statements, any other statements related to debt and your last 12 months of payments made from any of your business bank accounts.
2. Go line by line through each expense (past and present) even if you are not incurring the expense anymore, and with a pen, mark the expense with a “P” for any expense that directly generates (P)rofit; “R” for any expense that, while necessary, can be (R)eplaced with a less expensive alternative; or “U” for any expense that is (U)nnecessary for delivering what you offer.
3. Review every expense, including salaries, commissions and bonuses for employees, rent for the office, equipment, health care, raw goods and your office Spotify subscription. Everything. If money goes out of the business, it needs to be categorized as “P,” “R” or “U.”
4. Now, circle any expense that is recurring even if it happens to be in a different amount.

Now Let's Do Some Math

1. Add up all the expenses for the year. Exclude tax payments and owner's distributions or salaries. Now, divide that number by 12 to determine your monthly “nut” — the total amount you have decided you need to cover each month.
2. Determine the difference between your current monthly operating expenses and the number it must be according to your previously determined OPEX allocation.

3. Work out a plan to cut expenses until you are operating at 10 percent below the target number on your Operating Expenses TAPs.

If your company is racking up debt, it is all too often because labor cost is too high. You need to let go of people.

Evaluate each person and determine if her role is mandatory for operations to continue. Next, evaluate your staff members. If they aren't directly generating profit, they need either to be moved within your business to help it become more profitable, or they might need to be removed from the company.

Time for More Cuts

Now that the hardest part is over, call your bank to stop all automatic withdrawals from all of your accounts except for any expenses that directly generate profit. Then, notify your vendors that you are stopping the withdrawals and will pay by check going forward. This will make you acutely aware of every payment you make.

Call each of your credit card companies and ask that you be issued a new card with a new number. Tell the credit card company that no payments that were being processed on your old card should transfer to your new one. This step will stop automatic charges.

Next, cut any unnecessary expense listed. If you doubt whether you can really cut it, just cut it. An expense is always easy to add back. For the replaceable expenses, it is time to negotiate. Everything is up for negotiation — your rent, your credit card rates and debt, your vendors' bills, your software license, your internet bill, etc. ●

Find Money Within Your Business

Cranking up the sales team is not going to help your company if you don't have efficiencies in place because, ultimately, whatever new client revenue you generate will have corresponding costs. If you want to increase profitability, you must first build efficiencies.

Look at efficiency in every aspect of your business. Serving the same types of clients with the same or very similar problems and perfecting your solutions so you can use them consistently to fix their problems are two routes of efficiencies. You want to duplicate your best clients, those who have a consistent need; and in turn, you want to reduce the variety of things you do for the fewest that will best serve your best clients' needs.

Most entrepreneurs focus only on tiny improvements — “How do I do this a couple minutes faster?” Small questions yield only small answers. You want both the

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incremental improvements and the landslide discoveries, and you'll find both of those with big questions.

Fire Bad Clients

Letting go of clients who drain you and eat up your profit margins is a way to make space for clients you can serve exceptionally well by doing what you do best and with fewer resources.

Clone Your Best Clients

Think of your favorite client: The client who pays you what you're worth, on time and without question. Now, imagine that this client had five identical-twin companies that all wanted to work with you. Wouldn't that boost your business?

Having clients with similar needs and behaviors offers a few profit-making benefits:

1. You will become superefficient because you now serve very few but consistent needs rather than an excessive array of needs.
2. You will love working with your clones, which means you will naturally and automatically provide better service.
3. Marketing will become automatic. Your best clients hang out with other business leaders who have the "best client" qualities you're looking for. Your best clients will talk you up every chance they get. ●

How To Keep It From Falling Apart

The worst enemy of Profit First is *you*. The system is simple, but you must have the discipline to implement it consistently.

Common Mistakes

1. **Going It Alone.** Going it alone is the biggest mistake entrepreneurs make when implementing Profit First. Getting an accountability buddy will make sure you let the system work.
2. **Too Much Too Soon.** It is extremely common for entrepreneurs to start putting 20 or 30 percent into their PROFIT accounts right out of the gate. The next month, they realize they can't afford it and pull the money back out to pay bills, which defeats the entire process.
3. **Grow First and Profit Later.** Too many entrepreneurs believe that you can only have one or the

other: profit or growth. The healthiest companies figure out how to consistently be profitable first and then do everything to grow that.

4. **Cutting the Wrong Costs.** Not all expenses should be cut. Invest in assets, which are defined as things that bring more efficiency to your business by allowing you to get more results at a lower cost per result.
5. **Plowing Back and Reinvesting.** When you find yourself in a situation in which you feel the need to plow back your profits, stop to reassess. There is always a better, more sustainable way to maintain the health of your business.
6. **Raiding the Tax Account.** As your profitability grows, your taxes will, too. So don't steal from your TAX account thinking you won't need that money for taxes. You will.
7. **Adding Complexity.** The system has been designed to work with how you naturally work. Don't overthink it. Don't add complexity. Don't try to outsmart the system.
8. **Skipping the Bank Accounts.** Profit First at the bank will be in your face every time you look at the accounts, which enables you to manage profitability and cash-flow decisions in real time. Setting up your accounts means you can't avoid it, and that is exactly how it needs to be.

It's easy to fall back into the old ways because they seem to make sense (they don't), because your accountant says you shouldn't bother (you should), or because you think you were happier doing things the old way (you weren't).

To quote the great athlete Sir Roger Bannister, who broke the 4-minute mile, "The man who can drive himself further once the effort gets painful is the man who will win." ●

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Summary: *The Pumpkin Plan* by Mike Michalowicz. Inspired by an article about how to grow a giant pumpkin, Mike Michalowicz modified the step-by-step approach to growing a business. Applying it to his own company, he created a multimillion-dollar industry leader.

Webinar: *The Most Common Mistakes Entrepreneurs Make* by MJ Gottlieb. MJ Gottlieb provides a highly animated, layman's terms presentation for aspiring entrepreneurs, putting each story in the form of a "case study" explaining both the crime committed ("The Wrong") and the lesson learned ("The Right").

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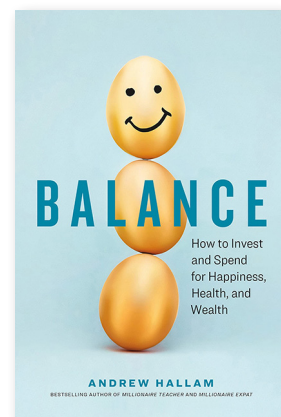
Balance

Andrew Hallam

Balance

How to Invest and Spend for Happiness,
Health, and Wealth

by **Andrew Hallam**



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THE SUMMARY IN BRIEF

Sometimes it takes more than one question to get to the root of our motivations in life. In fact, Andrew Hallam starts his book ***Balance: How to Invest and Spend for Happiness, Health, and Wealth*** by describing a conversation between himself and his students whose educational aspirations have them locking their sights on Ivy League universities – he asks them, “why?”, as a means to find the underlying motivation for their drive in life. The same philosophy can be transferred to other areas of our lives – why do we do the things we do? Are we motivated by wealth, health, happiness, or something else entirely? Andrew takes us on a journey to discover the underlying motivations in our life and why balance is ultimately the best way to ensure you succeed and meet your goals.

Navigating the investment waters can be difficult – but after experiencing this book, you will be able to find the motivation and solutions necessary to find the balance needed to prosper and enjoy life.

IN THIS SUMMARY, YOU WILL LEARN:

- How asking “why” can change your view of the world.
- Why finding a balance between money, relationships, health, and purpose can help you go further.
- How to invest the right way from the start (including your children’s future).
- How to maximize your retirement while living life to the fullest.

Introduction

Constantly asking the question “why” can help you get to a place of understanding; all be it a place that begins to sound the same – ambition and goals driven by the same four quadrants of a successful life:

- Having enough money
- Maintaining strong relationships
- Maximizing your physical and mental health
- Living with a sense of purpose

Instead of focusing on one quadrant over another, finding the balance among them becomes necessary. When one of the quadrants lacks, the entire table becomes unstable, and finding satisfaction in life becomes impossible. The purpose of this book is to help individuals on their personal quest for wellness. Using stories and research to describe relationships between money, health, happiness, and purpose while offering suggestions that allow you to live your best life possible – if you can keep an open mind, respect the research, and be open to the idea of dancing to a beat that is different than your neighbor – you might just be in luck.

The Grim Reaper Asks, What Do You Value More, Your Stuff Or Your Life?

For many of us, buying things doesn’t improve our lives – in many cases borrowing money can really drag us down. We get hung up on the money translating to the status quo when in fact, we often overcompensate by purchasing items we can hardly afford to seem above our means. In the process, we have tried to normalize things like credit card debt and auto loans – who are we helping with these?

Cars are one of the greatest personal wealth destroyers that we bring into our lives. We often borrow to get the cars we want, but they begin losing value the moment we drive them off the lot. Sam Dogan’s approach is to only purchase a car worth 10% of your gross annual income. So, if you make \$40,000 per year, you should only spend approximately \$4,000 on a car. Whether or not you want to live by this principle, you should beware of the slippery slope of the “upgrade.” The desire to gain bigger and better can cloud our judgment, and we lose sight of the balance in our lives.

As a rule of thumb, always ask yourself if the purchase you want to make creates an experience that you wouldn’t have had otherwise. You must answer this to determine if the purchase provides an experience that boosts happiness

and well-being. Would you take it with you as one of your limited desert island treasures?

Would You Say No To A High-Paying Job?

There is a relationship between happiness, income, and the place you choose to live. A harmonious marriage of these can create balance, but there are a few tips you can use to live better. If you are considering a new position, don’t do it solely on the potential for extra income, especially if you already earn enough to cover your basic needs and additional savings. The prospect of a new job can culminate in reduced life satisfaction by taking time away from your family, hobbies, and all the things you love.

When applicable, try to align yourself with a career that aligns with your passions; they won’t feel as much like work. You should consider living in a neighborhood where financial resources are in alignment. Even though the neighborhood is ideal, make sure you don’t wind up with a long commute to work – it would be counterproductive. Mindset is key, even if you can’t choose where you live. Always focus on what you have, not what you don’t have.

Building Social Relationships To Live Better And Longer

Relationships with other people play a large role in living better and longer. You have to increase the amount of time you spend with people, especially those you love and respect – these people are necessary for living well. In terms of relationships, go narrow and deep (few friends) versus keeping your pool broad and shallow (multiple acquaintances).

Always be true to yourself if you want to live better as a person. Don’t try chasing after a status or particular lifestyle just because you think others will like you better for it. You also have to limit the amount of social media in your life – your life and health will benefit from extracting this drama from your life. The better your relationships (and genuine), the more you will find out how your superpowers are enhanced by those you build meaningful relationships.

Learning From Gratitude

Life is like a dark hourglass – we never know when the sand will run out. We have to strive to live the best life we can – today, tomorrow, and onward. The sad realization is that many people live unhealthy financial lives, spending too much, borrowing too much, and ignoring their savings. Re-

alizing this will help you stop envying those who have more than you – they are not living their best life.

You have to take the time necessary to appreciate what you have – not what you want. One way of doing this is starting a gratitude journal. Start talking to people about money – we often avoid the subject, but it is time that the discussions were normalized. The best way to open the communication channel is by finding someone with the same goals and values as yourself.

Afford Anything, But Not Everything: Spending Decisions That Are Worth A Million Dollars

There are many faces to our financial decisions, but you should always look at another perspective – how would your money grow if you invested it, not spend it? Start by using an app to help you track what you spend and categorize your expenses. Think about your household as if it were a business. Any business that doesn't track its expenses is likely to go bankrupt – you can learn many lessons by changing how you view your household. Start looking at what you are spending – is there a way to cut down these expenses and still live comfortably? If you can cut things without sacrificing your overall comfort and save extra, why wouldn't you at least consider it?

Daily Routines That Help You Make Money

Looking to secure future financial security? By investing regular sums, regardless of the short-term performance of the market, you can enjoy future financial security. A great strategy is owning a sliver of every business in a portfolio of index funds, or exchange-traded funds (ETFs) increases your odds of investment success.

Don't fear the short-term fluctuations in the market. The best way to understand is by studying historical stock returns so you can keep realistic expectations. As a rule of thumb, save money for a down payment on a home or keep an emergency fund on hand – don't put those particular funds into the stock market – keep those in a savings account or money market account for accessibility.

Don't Let A Financial Advisor Pour Water In Your Trumpet: Hidden Fees Drown Out Returns

If you are considering investing, put the odds in your favor. Evidence shows that the most effective way to meet the vast majority of professional investors is to build a diversified

portfolio of low-cost index funds. Don't trust anyone who tries to give you financial advice – even an author with life experience. Always do your own research and verification process – you are the one who determines your financial future. Always use the facts to arm yourself in the financial world – don't let an advisor fool you when selling you actively managed funds. Keep in mind that not all advisors are evil; most just don't know what they don't know.

Set It And Forget It: Hands-Off Investing Boosts Happiness And Profits

Always choose your investment service based on your personality. While full-service advisors can temper emotions, you should only use advisors who exclusively use index funds (or ETFs). Looking for service but want to pay less? Consider an automated robo advisor – this will help you manage your funds hands-free and at a lower cost.

When you spend less time thinking about your investments, the more money you are likely to make and the more happiness you will gain. When you are a DIY investor, all-in-one portfolios of index funds or all-in-one portfolios of ETFs make the process easier and help collar your inner speculator. If you are looking for something that can help you purchase such products, PlanVision can show you how for about \$200 a year.

How Well Do You Know Yourself? The Challenge Of Picking A Portfolio Allocation That Will Keep You On Track

Nobody knows how the stock market will pan out – fluctuation happens regularly. To be successful, you have to be consistent – adding money monthly, maintaining allocation, and not speculating are vital. Don't depend on market timing, either. Think of it like going to a casino – the house always wins!

Are you a retiree? Instead of focusing on forecasts and portfolio values, stick to an inflation-adjusted four percent withdrawal plan. Those who do can see their way through a market crash with approximately 30 years' worth of wealth to tide them over – just don't give in to the hype of an inflation-adjusted raise.

Men and women should invest equally – carrying their own weight in the process. Sometimes one member of the couple feels as though they are responsible for the “heavy lifting” when the reality is that they both benefit from doing their fair share.

Happy Planet, Happy People

Investment philosophies can be used to invest in environmentally sustainable funds. These funds still have the capacity to take out the pros with little effort required. If you are investing environmentally, vote for those who have environmental agendas. These are the people who will help make a difference in the future.

Create an environmentally friendly lifestyle for yourself, too. Try flying less frequently, buying locally, saying no to single-plastic water bottles, eating less meat, and reducing and reusing before you recycle. Before you make a major decision, especially with your consumption, consider the cradle-to-grave impact. Use the full process – manufacturing, packaging, and shipping for consumption and disposal. Make sure that you make SMART goals that positively impact the environment. Consider buying less of everything. The reduction should help you improve your happiness, your financials, and the future of your children and grandchildren. Additionally, some of your decisions can help you provide solutions that also give Mother Earth a break.

From Little Acorns...Helping Your Children Succeed

Children are the future, and we are the ones who have to teach them how their actions now will impact life later. Starting now, give your children household chores at an early age, including limiting their screen time. As a result, their social skills and sense of responsibility will improve as a result.

Instill in them at a young age that their money can be split into thirds – share, invest, and spend. Setting clear ground rules early on can help them commit to a healthier money management solution. The more you model sound finan-

cial decisions, your children can learn from these. Provide opportunities for your child to build their own financial muscles, responsibility, and personal pride. This can extend into college – you should help them with their costs, but don't pay their way. Give them some responsibility over their college expenses.

Rethink Retirement: Boost Well-Being And Longevity In Your Golden Years

Early or conventional retirement is overrated. You have to find a balance between work and play – that is the key to success. According to research, a lot of retirement-age individuals suggest that you might enjoy a happier and healthier life working part-time during retirement. Think outside the box – a mini-retirement can offer variety and stretch your perception of time. Consider living full-time or part-time in a lower-cost destination. When doing this, you can slash costs and increase living standards while expanding your perception of time.

Conclusion

No one is happy all the time – the overriding premise is: when you choose to buy something, live somewhere, do something, or accept a job, start by asking this question – why? You have to focus on your core values and learn how behavioral science might help boost your overall life satisfaction. Remember, balance is crucial – focus on the four quadrants; having enough money, maintaining relationships, maximizing health, and living with purpose. Always try to be yourself, but be your best self.



Andrew Hallam is the international best-selling author of *Balance: How to Invest and Spend for Happiness, Health and Wealth*; *Millionaire Teacher: The Nine Rules of Wealth You Should Have Learned in School* and *Millionaire Expat: How To Build Wealth Living Overseas*. Profiled on such media as CNBC, and The Wall Street Journal, he's also the first person to have a #1 selling finance book on Amazon USA, Amazon Canada and Amazon UAE. He has written columns for The Globe and Mail, Canadian Business, MoneySense, Swissquote and AssetBuilder.

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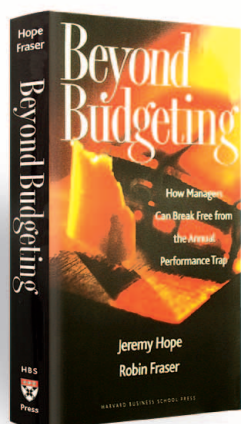
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Beyond Budgeting

Jeremy Hope and Robin Fraser

SOUNDVIEW Executive Book Summaries®

FILE: FINANCIAL/ACCOUNTING



By Jeremy Hope and Robin Fraser

How Managers Can Break Free From The Annual Performance Trap

BEYOND BUDGETING

THE SUMMARY IN BRIEF

It's no secret that annual budgeting processes are time-consuming, add little value and prevent managers from responding quickly to changes in today's business environment. Traditional budgeting's focus on fixed targets and performance incentives often leads to dysfunctional, even unethical, management behavior. But organizations can break free from the annual budget trap once and for all.

Beyond Budgeting presents an alternative, coherent management model that enables companies to manage performance through processes specifically tailored to today's volatile marketplace. Based on the decision-making needs of front-line managers, this model lets you take advantage of two major opportunities. Your company can create a set of adaptive management processes that replace centrally controlled, predetermined goals with self-regulating, relative competitive benchmarks and transfer the power and decision-making authority from the center of the organization to the front line.

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What You'll Learn In This Summary

- ✓ **Why the annual budget and performance contract is a trap and how you can break free from it.** Do away with budgets and you will save time and money while you create a more ethical and profitable company.
- ✓ **How creating an adaptive process lets managers focus on continuous value creation instead of meeting budget goals.** No longer will managers meet artificial, internally set goals. Instead they will measure their performance against others in the industry as managers set stretch goals.
- ✓ **How and why to create a radically decentralized organization to become a high performance organization.** By decentralizing, you create a vital, responsive organization.
- ✓ **What you need to do to realize the full potential of management models like customer relations management, benchmarking, Balanced Scorecards, activity-based management and rolling forecasts.**

BEYOND BUDGETING

by Jeremy Hope and Robin Fraser

— THE COMPLETE SUMMARY

The Annual Performance Trap

Like them or loathe them, everyone has a view about budgets. CEOs like the warm feeling they get when they see the year-end profit forecasts. But they might be anxious about the reliability of the assumptions and the firm's ability to respond to change. CFOs like the way they are able to tie operating managers to fixed performance contracts (fixed targets reinforced by incentives). But they also know that the process takes too long and adds little value. Operating managers like "knowing where they stand." But they are also concerned about the time wasted and that fixed performance contracts lead to decision paralysis and cosmetic accounting rather than decisive action and ethical reporting.

The consensus in American business circles is that the budgeting process isn't all it could be. Dissatisfaction is rampant. There are three main reasons for this:

- Budgeting is cumbersome and too expensive;
- Budgeting is out of kilter with the competitive environment and no longer meets the needs of either executives or operating managers; and

- "Gaming the numbers" has risen to an unacceptable level.

Budgeting is Cumbersome and Too Expensive

The budgeting process is a deeply embedded annual ritual. It absorbs huge amounts of time for an uncertain benefit. Typically, it starts with a mission statement that sets out the aims of the business followed by a group strategic plan that sets the direction and high-level goals of the firm. These form the framework for a budgeting process that grinds its way through countless meetings.

The average time consumed by the budgeting process is between four and five months, absorbing 20 to 30 percent of senior executives' and financial managers' time. A 1998 benchmarking study showed that the average company invested more than 25,000 person-days per billion dollars in revenue in the planning and performance measurement processes.

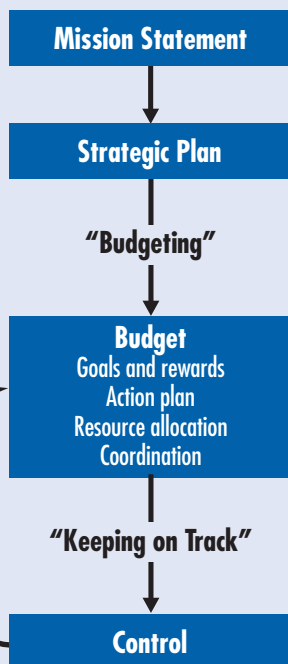
For any firms involved in mergers, acquisitions, disposals and other reorganizations, the budgeting workload can be overwhelming. The result is a finance team under constant pressure to reconfigure the numbers rather than support hard-pressed managers with the information they need to make decisions.

Budgeting Is Out of Kilter With the Competitive Environment

The pressure on corporate performance has become intense. Shareholders demand that firms be at or near the top of their industry peer group. Intellectual capital, such as brands, loyal customers and proven manage-

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The Traditional Budgeting Process



The authors: Jeremy Hope and Robin Fraser are Directors of the Beyond Budgeting Round Table, a collaborative that offers shared learning, performance management research and consulting support.

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The Annual Performance Trap

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ment teams, drives shareholder value. Product and strategy cycles have shortened. Prices and margins are under pressure and customers are becoming fickle. The old command-and-control management style is out of tune with the new need for agile and adaptive leadership and the need to transfer more power and authority to people closer to the customer.

Few of the innovative management tools of the past decade have been used to fundamentally transform the performance management process. At best they have made marginal improvements to a broken system. Few have achieved their potential.

‘Gaming the Numbers’ Is at Unacceptable Levels

Budgets started life in the 1920s as tools for managing costs and cash flows in large organizations. By the 1960s they had mutated into fixed performance contracts. By then companies were using accounting results such as costs, net income and return-on-investment (ROI) to do more than keep score but also to motivate operations personnel at all levels. By the 1970s, financial indicators were being used to manage the business.

This led to the increased use of the fixed performance contract as the basis for setting fixed targets against which performance was evaluated and rewarded. The fixed performance contract begins with an “earnings” contract between senior executives and external parties, such as investors or bankers, and then cascades down the organization in the form of “budget” contracts between senior executives and operating managers.

The typical budget contract provides:

- **A fixed target, such as sales, profits, costs and return on capital.**
- **An incentive for meeting or exceeding targets.**
- **An agreed-upon strategic and financial plan.**
- **A statement of resources available.**
- **A commitment to cross-company actions such as a promise by production to meet a sales plan target.**
- **A reporting schedule so that progress can be monitored.**

One problem with this management method is that it may lead to fraud. Fear of failure (to meet the goals specified from above) is often the underlying cause. This was evident at both Enron and WorldCom. When senior executives and operating managers commit to overly aggressive targets, they may fudge the numbers to meet them. The fixed performance contract is a deadly virus. It can lay dormant for years until an aggressive “management by the numbers” leader comes along and activates it. It is a dismal way to manage a business. ■

Breaking Free

There are organizations that have found a better way. They have eliminated the annual cycle of preparing, submitting, negotiating, and agreeing upon a budget by department, function, business unit, division or even the whole organization. The result has been to save months of work. The budget no longer represents an annual fixed performance contract that defines what subordinates must deliver or how resources are allocated or what business units must make and sell. The budget no longer determines how the performance of those units and their people will be evaluated and rewarded.

Who are these organizations? They vary in size from a small charity to a huge global firm. They have gone beyond budgeting, enabling more adaptive management processing and a radically decentralized organization.

The Adaptive Process Opportunity

Rhodia is a large specialty chemical company with sales of \$7.2 billion operating in many global consumer markets. The annual budgeting process took six months and was slowing down its ability to respond to the market. In 1999, the company replaced it with two performance management cycles. One takes a strategic view and continually looks two to five years ahead, with an annual review. The other takes an operational view and looks five to eight quarters ahead, with a quarterly review. Managers now focus on medium-term strategy rather than short-term fixed targets.

The contrast between the old and new way of doing things is dramatic. It looks like this:

Targets: Instead of setting a fixed sales/profit target, the organization trusts everyone to maximize profit potential by continuously improving against an agreed-upon benchmark and remaining in the top of the industry peer group.

Rewards: Instead of a fixed reward, managers are rewarded by a peer review panel based on performance and with “hindsight” at the end of each year.

Plans: Instead of an agreed action plan, the organization trusts everyone to take whatever action is needed to meet medium-term goals.

Resources: Instead of a fixed budget amount, managers trust the organization to provide the resources needed to meet goals, and management trusts everyone will keep resources within agreed-upon key performance indicators.

Coordination: Instead of an imposed-from-above coordination of activities, the organization trusts that everyone will work together according to periodic agreements and customer requirements.

Controls: Instead of monthly performance monitor-

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Breaking Free

(continued from page 3)

ing, the organization trusts everyone will provide an accurate forecast based on the most likely outcome. The organization will only interfere when the indicators move out of bounds.

The principles of *Beyond Budgeting* offer a new coherent management model. It assumes that front-line managers are able to regulate their own performance. Senior executives provide a supportive role. They challenge and coach, but decisions are taken locally within a clear governance framework based on principles, values and boundaries. In the new coherence, relative improvement contracts, strategic models, rolling forecasts and service-level agreements make sense.

Radical Decentralization

There must also be a wider coherence among the organization's success factors, its strategy, its management processes, and its leadership styles and culture. The process is about lifting the burden of bureaucracy from the shoulders of front-line people, eradicating the

dependency culture and enabling people to accept even more responsibility for their own performance.

The delegation of decision-making and spending authority has always been one of the key functions of budgeting. However, this delegation usually occurs within a regime of compliance and control. When that power is transferred from the center to operating managers and their teams, vesting them with the authority to use their judgment and initiative to achieve results without being constrained by some specific plan or agreement, the organization creates an empowered work force. That in turn drives superior performance.

Radical decentralization requires that leaders share six common principles. These are:

1. **Build a governance framework based on clear principles and boundaries.**
2. **Create a high-performance climate based on the visibility of relative success at every level.**
3. **Provide front-line teams with the freedom to make decisions that are consistent with governance principles and strategic goals.**
4. **Place the responsibility for value-creating decisions on teams.**
5. **Focus teams on customer outcomes.**
6. **Support open and ethical information systems.**

Going beyond budgeting provides benefits for shareholders, too. It addresses two primary issues investors face. The first is whether they believe an organization will produce sustainable growth in shareholder wealth. The second is whether they trust the management team. ■

Svenska Handelsbanken Decentralizes

Swedish bank Svenska Handelsbanken was struggling and losing customers, especially to a smaller rival run by Dr. Jan Wallander. So the bank invited him to join it as its new CEO. He accepted with the proviso that the bank would have to radically decentralize operations and abandon its budgeting process.

Convincing others that the organization should not be coordinated and controlled from the center was a tough challenge. Wallander was resolute. He believed that what holds an organization together is a commitment to a clear purpose, principles and values. Above all, Wallander believed in setting people free — free from stifling bureaucracies, predetermined plans, fear of failing to meet fixed targets, and forced cross-company actions designed by central planners. He opened up the information system so that everyone could see the same information at the same time. Sharing and cooperating were no longer choices: They happened automatically.

Since abandoning the budgeting model in the 1970s, the bank has produced outstanding return for shareholders, consistently beating all its European rivals on the key ratios of cost-to-income and costs-to-total assets. The CEO credits its decentralized management model as a major source of competitive advantage.

How Adaptive Process Opportunity Lets Managers Focus on Value Creation

Breaking free from the fixed performance contract is key to unlocking stretch targets, implementing adaptive processes and eradicating most of the undesirable game-playing that pervades the budgeting process. Break free by:

- **Setting stretch goals aimed at relative improvement.** You do this by telling the team that they should set their goals based on their highest aspirations. Just make certain that the stretch goal isn't seen as a fixed target against which performance will be evaluated. Also make sure that goals are set relative to external benchmarks. Benchmark goals are based on industry best-in-class performance measures, and teams are given an extended period of time to reach them. Most companies set the goal as being in the top quartile of their peer group. You can also set goals relative to internal peers as a way to boost continual improvement.

(continued on page 5)

How Adaptive Process Opportunity Lets Managers Focus on Value Creation

(continued from page 4)

- **Base evaluation and rewards on relative improvement contracts with hindsight.** Do not link rewards to fixed targets agreed upon in advance. Set bonuses based on a relative improvement contract that involves a whole team setting and meeting a range of performance benchmarks over a period of time. Use a peer review group to evaluate their performance with the benefit of hindsight. The peer panel must ask, “Did they do as well as they could have done given what we know about the profit-making opportunities during the period and what the competition has achieved?”
- **Make action planning a continuous and inclusive process.** The calendar or fiscal year may be an appropriate time period for reporting results to investors but it is unlikely to be for managing the business. Focus instead on continuous value creation.
- **Make needed resources available.** Managers need fast access to resources. Although you may provide parameters within which resources can be committed, within these limits managers should have wide discretion over how they utilize resources. Provide fast-track approval for major projects outside the budgeting process. Major projects should be approved as needed, not because it is the right time of the year. Managers should have the power to implement small projects.
- **Coordinate cross-company actions according to prevailing customer demand.** Let the pace of market demand set commitments. Whenever possible respond to unanticipated customer requests. Give those who are making the front-line decisions access to customer profitability information or they risk creating losses as the costs of customizing affect customer profitability.
- **Base controls on effective governance and on a range of relative performance indicators.** Decentralizing means making the switch from central control to multilevel controls. Multilevel controls means knowing what is going on and interfering only when necessary. Ensure that there is effective governance from the center which supports local decision-making.

Applying these principles results in aspirational goals, reduced gaming, ambitious strategies, fast response, reduced waste, improved customer service, and an atmosphere that promotes learning and ethical behavior.

Insights into Implementation

Little uniformity exists in how firms have approached the implementation of beyond budgeting. Though some have used consultants to help with the process design, few have used them to aid with the abandonment of the budgeting process and the implementation of its

How the Board at Borealis Was Convinced

Borealis is one of the largest petrochemical companies in the world. Output from its products can be found in thousands of everyday products from diapers to housewares to power cables. It was formed in Denmark in 1994 as a joint venture between two Nordic oil companies (Statoil of Norway and Neste of Finland). It inherited most of its processes, systems and people from the parents. Heading up the team that would create a Borealis unencumbered by the burdens of budgeting was Bjarte Bognses. His team's first job was to convince the board that doing away with the budgeting process was a good idea.

The team was confronted by board members who asked, “How do we control the business without budgets?” and “Why take the risk?” Through a series of meetings, the team won the board over. They discussed two primary risks: that costs would explode because of fewer controls and that decision making would be paralyzed. Bognses addressed these concerns like this:

“We have good, capable people who take their jobs seriously. They know what to do. The likelihood of chaos is minimal. We should also consider the risks of not doing it. What would happen? We would carry on as normal with no one challenging costs and everyone demanding more resources than the company can afford.” He won the board over and the company has become a powerhouse.

replacement. After surveying successful companies that have gone through the process, the following guidelines help shed light on how they managed the change-over:

- **Define the case for change and an outline vision.** Implementing beyond budgeting, even incrementally, is a significant change and needs to be handled accordingly. Going beyond budgeting is about changing a mind set. You won't be able to build support from the top and a groundswell below unless you make a convincing case for change that includes a vision of how things will be. The case for change should be both a clear statement of the “current pain” experienced with the budget-based model and the benefits to be gained by replacing it with something different.
- **Convince the board.** One of the key roles for the project team will be to convince the board that managing without budgets will bring significant benefits without too many down sides. The board will question whether the firm can maintain effective corporate governance and internal controls and whether changes will affect the firm's ability to forecast future earnings and

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How Adaptive Process Opportunity Lets Managers Focus on Value Creation

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avoid upsetting the market with unpleasant surprises.

- **Get started.** Remind people that the change will actually mean less work, not more. A great approach is to eliminate the next budgeting process right away and immediately replace it with the new process.

- **Design the model and implement the process.** The annual budgeting process connects every part of an organization and influences how people think and behave at every level. Any changes must therefore take into account these effects. Realign recognition and rewards, and reestablish coherence in the whole process.

- **Train and educate people.** Combine a well-designed system and a rollout program with excellent training materials. Make sure everyone becomes familiar with the new processes as soon as possible.

- **Rethink the role of finance.** The success of managing without a budget will be fleeting unless the role played by the finance team is realigned with the new processes. This is a time of maximum uncertainty for the finance team. They need to know where they stand. Ensure they have the training to meet future challenges.

- **Change behavior.** Change will be driven by the new processes, not by management decree. Behavior change follows process change. With no detailed budget to define their targets and dictate their actions, managers must accept greater responsibility for their actions and more accountability for their results.

- **Evaluate the benefits.** Demonstrating short-term wins is important to keep resistors at bay. Show them hard evidence of success. Short-term wins should have three characteristics: They should be visible, unambiguous and clearly related to the changes. ■

For Additional Information on How Not to Implement Change, go to: <http://my.summary.com>

Principles of Radical Decentralization

Effective empowerment is the product of freedom multiplied by capability. As with any mathematical equation, if one of the variables is zero, the result will also be zero. This explains why so many attempts at empowerment fail. Few leaders seem capable of supporting both variables at the same time. To make it work, you need to understand seven leadership principles. They are:

1. **Provide a governance framework based on clear principles and boundaries.** People at all levels of a firm need clear guidelines so they know what they can and

cannot do. In control-oriented organizations, these were based on mission statements, plans and budgets. In empowered organizations, they are based on clear principles, values and boundaries. Essential boundaries include the strategic domain; codes of conduct; ethical and environmental considerations within which managers can operate; time between reporting intervals; and the area between what managers must do and what they might do.

2. **Create a high-performance climate based on relative success.** When senior executives fixate on meeting numbers every quarter and year-end, their obsession drives dysfunctional and disruptive behavior at every level. Managing without fixed targets and incentives leads to strong and consistent levels of performance when leaders champion relative performance, challenge ambition, and balance competition and cooperation.

Break Free From Fixed Performance Contracts

3. **Fixed performance contracts tie operations managers to specific agreements and reduce their flexibility.** Breaking free from these contracts is the single most important step that leaders can take to create an empowerment culture where beating the competition is what's important, not meeting some arbitrary internal goal.

4. **Give people freedom to make local decisions that are consistent with governance principles and the organization's goals.** Teams at every level need strategic direction. To instill a culture of responsibility rather than dependency, leaders should challenge assumptions and risks, involve everyone in strategy, and empower teams to make decisions.

5. **Place responsibility for value-creating decisions on front-line teams.** Decentralizing allows teams to respond to local opportunities in ways that create a more adaptive organization. Changing functional mind-sets to team-based mind-sets is a major cultural challenge. To embed the philosophy of teamwork and personal responsibility, leaders must create a network of small, customer-oriented teams, and base recruitment on a potential employee's fit with the team.

6. **Make people accountable for customer outcomes.** As you move beyond budgeting, your structure should become more networked, using independent units with distributed capabilities and expertise. You will be able to locate and combine expertise across the network and seamlessly bring collective expertise together to provide customer solutions. That way, teams can share knowledge across the business as they respond to customer demands.

7. **Support open and ethical information systems providing "one truth" throughout the organization.** Resist the temptation to hide facts from the organization. Good and bad news must be shared so potential problems can be solved before they become crises. ■

Insights Into Changing Centralized Mind-Sets

Changing the centralized mind-set is extremely difficult and depends on rooting out the budgeting and dependency culture. The problem is a lack of understanding of what leaders must do to make empowerment work effectively. To make it work, they must abandon:

- **fixed performance contracts**
- **command-and-control management**
- **the dependency culture**
- **central resource allocation**
- **multilayered functional hierarchies**
- **closed information systems**

To make the leap, the organization and everyone in it must see real benefits. The main benefits of empowerment are unlikely to be realized until the budget contract has been abandoned and alternative processes have been put into place. It is the new processes that change actions and behavior.

‘We Really Mean It’

Abandoning the budget is one of the most positive actions leaders can take that say to people “we really mean it.” Managers are immediately aware that there is no detailed plan that dictates their actions. They must think for themselves and take responsibility. The learning process is both fast and steep. Managers suddenly have to understand strategy at both corporate and local levels and know the principles and boundaries within which they are to operate. They have to understand that if they make mistakes, they won’t be punished.

For many managers steeped in the command-and-control culture, devolving responsibility is airy-fairy stuff. Their job as they see it is to ensure that leaders have control, and that can only be done with hard numbers. These managers exist in every organization and are usually a difficult and vocal minority. The answer isn’t to cater to them but to maximize attention to the top 90 percent or so who do get it — who understand the benefits of decentralization. Promote the people who embrace the new values and it will take root.

Some companies have found that the turning point in their switch to a culture of responsibility was when they changed how people were recognized and rewarded.

The Roles of Systems and Tools

Six tools are especially helpful in going beyond budgeting. These are:

1. **Shareholder value models** that align decisions of internal managers with the expectations and interests of external shareholders.
2. **Benchmarking models** align targets with external

How IKEA Shares Information

IKEA’s chairman Ingvar Kamprad believes his company’s open information systems based on sharing of best practices give the international retailer a powerful competitive advantage. The company assigns “IKEA ambassadors” who are trained by the chairman himself in the company’s values and culture to key positions in every unit. They socialize newcomers into the IKEA philosophy and facilitate the transfer of ideas and best practices across the company’s operating units. As a result, newly set-up stores look at other stores and try their hardest to improve on them. Some of the distinguishing characteristics of the typical IKEA store have emerged out of this institutional entrepreneurship. These characteristics include cafeterias serving inexpensive exotic meals, such as Swedish meatballs; supervised play areas for children; and fully equipped baby-changing facilities.

or internal best practices and display the results in terms of rankings lists.

3. **Balanced Scorecards** provide a strategic framework for local decisions and provide leading indicators that tell managers if strategic goals are met.

4. **Activity-based management** informs managers about the causes of costs and better equips them to understand the net profit contributions of products, channels and customers.

5. **Customer relationship management tools** focus managerial actions on knowing and satisfying customer needs profitably.

6. **Enterprise information systems and rolling forecasts** join up the disparate functions of the organization and enable managers to relate work and cost inputs to customer outputs across the business.

Advocates of tools and information systems claim potentially powerful results if they are implemented in the right way. Tools and systems will work if the organization’s culture is supportive, its leaders are committed, and decision makers have the freedom to act on the information the tools provide. These are big “ifs.” The reality is that few tools achieve their objectives. The problem is that although all these tools have been implemented to overcome the systemic failures of the traditional model, the processes that underpinned those failures have been left in place. They have, in effect, been neutralized by the powerful antibodies of the budgeting immune system.

Budgets are barriers to the full implementation of the listed models. Removing the barriers is key to successful implementation of the models. For each model, the approach differs slightly. Here is the breakdown:

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Insights Into Changing Centralized Mind-Sets

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Shareholder value models let managers make decisions based on creating value greater than the cost of capital. By looking at every business as a portfolio of assets, products and customer segments, you can apply or reduce resources to them on the basis of their value-creating opportunities. This is hard to do in the traditional budgeting environment, where goals and resources are allocated for the year with little relationship to the allocations's impact on segments of the business. Some get more than they need in relation to their value-creation while others don't get enough. Instead, give front-line managers access to the information they need to see what creates the most value.

Measure Relative Success

Benchmark modeling is the philosophy of continuous improvement against a world-class standard. Well-chosen benchmarks ensure that firms are measuring performance against best industry standards rather than internally negotiated targets. Budgets are barriers to benchmarking because budget figures rarely are tied to external factors, but reflect realistic goals set internally. That can prevent moving ahead within the industry even as internally selected goals are met. It's the company's performance relative to the competition that counts, and that's what benchmarking measures. Using benchmarking also allows fair evaluation of efforts during turbulent times as it measures relative success.

The Balanced Scorecard was developed in the early 1990s as a response to the inadequate performance measurement systems that were primarily geared at reporting financial results against the budget. Scorecards are business units' strategy map. They set goals and provide an action plan for meeting those goals. Scorecards let front-line teams manage strategy by making sure goals and actions are aligned.

Understanding How Activities Add Value

Activity-based management models enable managers to better understand how activities add value to products and customers. An activity-based model can measure the cost of activities that are not readily accounted for in a budget that only shows the costs of functions and departments. By giving front-line employees access to activity-based information, they can make better decisions about their activities, and set priorities that lead to greater profitability.

Customer relationship management models identify what people must do to satisfy customers and build their loyalty and profitability now and in the future.

Front-line workers must be freed from budget goals that restrict their ability to build relationships.

Enterprise information systems and rolling forecasts should be used to monitor business changes and have the capability to do so almost in real time. ■

For Additional Information on how one company removed barriers to change, go to: <http://my.summary.com>

A Management Model For the 21st Century

The essence of the adaptive and decentralized management model is that by giving capable and committed people the authority to make fast decisions in their local markets, they will act responsibly; respond appropriately to the threats and opportunities confronting them; and with an eye on competitive performance, deliver consistent results. The focus of the model has moved from central to local control. This means that it is the local team that engages in planning and execution. They are the ones in touch with customer needs and the ones who have the freedom and capability to act.

Leaders also benefit. They have more time to challenge and support front-line people and reinforce principles and boundaries. Fast, transparent information ensures that there are many checks and balances that provide strong controls.

Lower Cost

Low cost is also a feature of the beyond budgeting company — an important feature in difficult times. By removing the cost of the budgeting process and eliminating the entitlement mentality that traditional budgets create, front-line managers can spend less when they need less while safe in the knowledge that they will be provided greater resources should they need them.

A decentralized company also encourages an environment of good governance and ethical behavior. People want to work in a more virtuous organization where they can trust people and be part of a team. They want to know what the company stands for and where it is headed. And, most important of all, they want more meaning in their working lives.

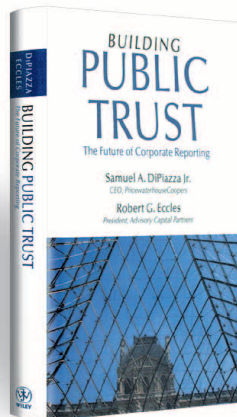
The adaptive and decentralized model is the answer. It is based on releasing the enterprise, energy and capabilities of people supported by adaptive processes, appropriate tools and clear leadership principles. There is no place for fixed performance contracts and remote-control management. Leaders need to place more faith, responsibility and trust in their operating people. The result will be a management model that offers a unique source of competitive advantage. ■

· Book 6 of 44 ·

Building Public Trust

Samuel A. DiPiazza, Jr. and Robert G. Eccles

SOUNDVIEW Executive Book Summaries®



By Samuel A. DiPiazza, Jr. and
Robert G. Eccles

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The Future of Corporate Reporting

BUILDING PUBLIC TRUST

THE SUMMARY IN BRIEF

The trust of the general public in the capital markets — which is recognized as the foundation of value creation all over the world — has been shaken. The straw that broke the camel's back was the Enron scandal — the largest market cap company to declare bankruptcy. But the signs of serious flaws in the capital markets were already present — from well-publicized business failures to the collapse of the Internet bubble to the decline and volatility of the equity markets.

Enron and other scandals have focused the public's attention on the institutions and people responsible for the information on which investors (as well as lenders, trading partners, customers and employees) depend. Public trust must be restored in this information — and in the purveyors of that information.

This summary offers a model of corporate reporting aimed at restoring that public trust and confidence. The goal of this model is to ensure a spirit of transparency, a culture of accountability and the participation of people of integrity in the corporate reporting process.

What You'll Learn In This Summary

✓ **The Key Elements Required to Rebuild Trust.** Restoring faith in the Corporate Reporting Supply Chain — which is responsible for supplying the information to investors, analysts and other stakeholders — means rebuilding three key elements that create public trust: a spirit of transparency, a culture of accountability and people of integrity.

✓ **A New Model of Corporate Reporting.** This summary introduces a new model of corporate reporting with three tiers of information: tier one is a Global GAAP; tier two consists of industry-specific standards; tier three consists of guidelines for company-specific information.

✓ **New Technology to Enhance Corporate Reporting.** A new Internet-based application allows information supplied through computers to be more flexible and useful to investors.

BUILDING PUBLIC TRUST

by Samuel A. DiPiazza, Jr. and Robert G. Eccles

— THE COMPLETE SUMMARY

Shaken Confidence: The Crisis In Corporate Reporting

Enron: The name once touted in books and seminars as a company with cutting-edge management techniques and creative strategies is now known simply as the largest market cap company in business history to go bankrupt. The consequences have been enormous: People not only lost their jobs; many of them lost their life savings. And blame is being put not only on the shoulders of top executives, but also on the shoulders of the accountants and lawyers whom the public believes helped them create the house of cards that eventually came crashing down.

Faith in corporate reporting is, perhaps, at an all-time low. Yet, without this faith, the capital markets cannot truly function.

It is time to address this crisis.

The Corporate Reporting Supply Chain

The Corporate Reporting Supply Chain is responsible for supplying the information on which investors (as well as lenders, trading partners, customers and employees) depend to make their financial decisions.

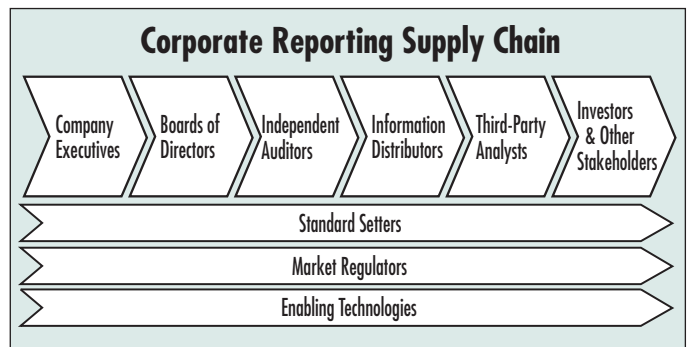
The Corporate Reporting Supply Chain begins with the company executives who prepare the financial statements that are reported to investors and stakeholders. These financial statements are approved by a board of directors, attested to by an independent auditing firm, analyzed by sell-side analysts and broadcast by information distributors, including data vendors and the news media. The entire chain is supported by standard setters, market regulators and enabling technologies. (See chart above).

The time has come to reexamine how the Corporate Reporting Supply Chain works and how it can be improved. Trust in the capital markets depends on faith in the Corporate Reporting Supply Chain — and that faith has been broken.

To restore that faith, corporate reporting reforms must rebuild the three key elements that create public trust in the markets: a spirit of transparency, a culture of accountability and people of integrity.

A Spirit of Transparency

The first key element of trust is a spirit of transparen-



cy. Corporations — that is, the people who work in corporations supported by the corporation's board of directors — have an obligation to provide the information that investors need to make the right investment decisions. Unfortunately, management and boards aren't making the information that they know investors need readily available.

A Culture of Accountability

The second key element of trust is a culture of accountability. Providing information is not enough. The members of the Corporate Reporting Supply Chain must feel a sense of accountability to the other members of the chain. Management, for example, must hold itself accountable to shareholders; it is responsible for using the shareholders' money to create value for those shareholders. The boards must see that this accountability is recognized and maintained.

People of Integrity

The third key element needed for public trust is peo-

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Shaken Confidence: The Crisis in Corporate Reporting

(continued from page 2)

ple of integrity. Despite rules and regulations, processes and best practices, and so forth, the entire structure of corporate reporting collapses if it is not supported by people of integrity trying to do the right thing.

The vision of corporate reporting presented in this summary is based on a new model of corporate disclosure and a fresh view of the responsibility of each link in the Corporate Reporting Supply Chain. This summary also provides suggestions about technology that can support responsible, transparent corporate reporting. ■

A Revised Model of Corporate Reporting

Public trust in corporate reporting — ensuring that investors and other stakeholders get the information they need to make appropriate decisions — cannot exist without corporate transparency. This summary offers a new model of corporate transparency, a three-tiered pyramid-shaped model. The three-tier model of corporate transparency, which is illustrated at right, can be described as follows:

The bottom and widest tier, Tier One, consists of a set of truly global generally accepted accounting principles — in other words, Global GAAP.

The second, middle tier, Tier Two, consists of industry-specific standards of measuring and reporting information — standards developed by the industries themselves.

And finally, Tier Three, the top, narrow third of the pyramid, consists of guidelines for company-specific information — such as strategy, plans, risk management practices, compensation policies, corporate governance and company-specific performance measures.

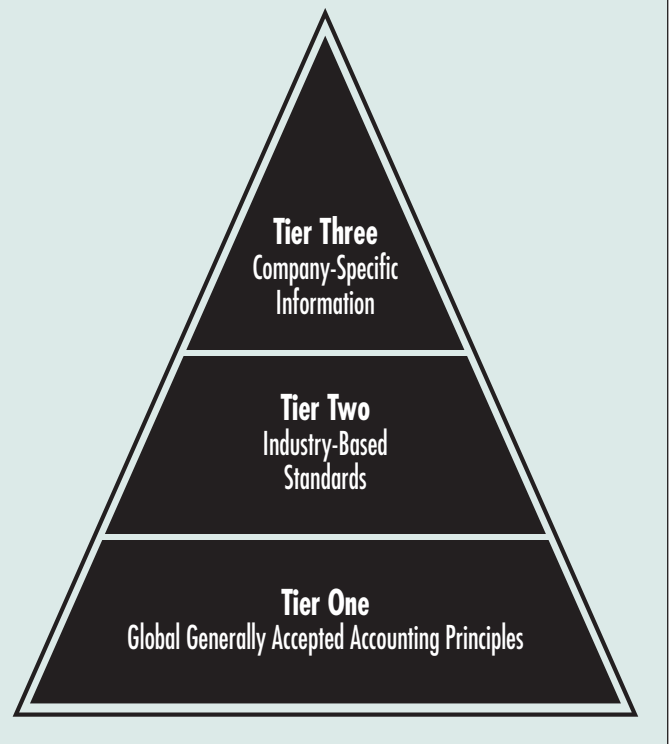
It's important to note that these are not three disconnected tiers; companies must provide the information in each tier in an integrated fashion, so that investors have a holistic view of the company — including the company's strategies, marketplace opportunities, value drivers and, of course, financial outcomes.

Let's take a look at each of these three tiers more closely. ■

Tier One: Standards for Global GAAP

The first tier of the model is global generally accepted accounting principles.

Three-Tier Model of Corporate Transparency



Companies today use a variety of generally accepted accounting principles (or global GAAP), but most of these principles are country-based. In addition, even the best country-GAAP standards are based on the historical cost model that many consider obsolete or, at best, irrelevant in the complex global environment of today's business.

Specifically, criticism about existing GAAP falls into three broad categories. Critics say that existing GAAP:

1. Fosters The Earnings Game (see sidebar on page 4) that is played by both management and the markets.
2. Does not account for or disclose certain types of information about intangible assets.
3. Does not communicate adequate information about value creation because it is a mixed model that includes historical cost, amortized cost, written down cost and fair value for certain financial instruments and other assets in some countries.

The closest one comes to a global GAAP is the International Financial Reporting Standards (IFRS), which by the year 2005 will be mandatory for countries in the European Union.

This is only a beginning, however.

The Case for Global Standards

Capital markets are as global today as product markets. Companies want access to capital from around the

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Tier One: Standards for Global GAAP

(continued from page 3)

world. They want to be able to dip into the pools of liquidity offered by the world's exchanges, including the London, Nasdaq or New York exchanges. Companies also want to be able to use their stock to make acquisitions in foreign companies. Today, however, accessing foreign capital markets is expensive and difficult with a global GAAP.

And it is not only companies that suffer the consequences, but investors as well. Global investors are hampered in their decision-making by accounting rules that differ from country to country.

Principles vs. Rules

For global GAAP to work, the people and institutions involved in the Corporate Reporting Supply Chain — from investors to government and regulators — must come to an agreement on the approach for developing standards and the scope of the applicability of those standards.

There are two approaches to developing standards: the rules approach, in which standards are narrowly defined in detail; and the principles approach, in which the standards provide broad guidelines for behavior. U.S. GAAP takes a rules approach, while the current International Financial Reporting Standards (IFRS) exemplify the principles approach.

The problem with the rules approach is that by narrowly defining what companies can do, the standards define what companies cannot do. As a result, companies can stick to the “letter” of the law, while avoiding the spirit of that law (“Hey,” says the accountant of dubious integrity, “nowhere does it say in these rules that I can’t do this!”).

The Right Approach

Global GAAP should be based on principles, not rules. These principles will succeed if they:

- 1. address issues of broad scope;**
- 2. reflect appropriately the economic substance of transactions;**
- 3. ensure that similar transactions are treated similarly;**
- 4. contain few alternatives, exceptions or compromises; and**
- 5. result in transparent and useful reporting and disclosure.**

The principles should be supported by rules only when necessary for clarification. Not everything must be defined specifically.

Transparency and Accountability

The spirit of transparency and a culture of accounta-

The Earnings Game

Many executives believe that the stock price of their companies is dependent on quarterly earnings figures. If quarterly earnings beat expectations, the stock price rises.

As a result of this belief, executives will often play “The Earnings Game.” The Earnings Game involves manipulating figures so that that earnings always beat expectations. For example, they may deliberately understate expected earnings for the next quarter and then benefit when the actual earnings beat those expectations.

Despite the popularity of The Earnings Game, however, empirical studies show that there is actually little relationship between quarterly earnings or net income and stock returns. Enron, for example, played The Earnings Game. For 12 straight quarters (starting with the last quarter of 1998) Enron met analysts’ estimates of earnings. In seven of those quarters, Enron’s stock went up after the earnings were announced. In five of those quarters, Enron’s stock went down.

Earnings are important, of course. But investors need other financial performance measures as well to make their decisions.

bility (for example, company executives should not use general principles as an opportunity for obfuscation, and auditing firms have a responsibility to help their clients provide the best information despite the ambiguous environment) are essential for the success of principles-based Global GAAP. In addition, standard setters and market regulators must be prepared to trust the integrity of managers and accounting professionals rather than constrain their behavior through a myriad of rules.

Accounting Concepts and Convergence Issues

There are fundamental accounting concepts that will need to be addressed and agreed upon to put global GAAP in place. These concepts include whether to value assets at cost or at fair market value; standards for reporting financial performance (for example, standard definitions for some financial measures); standards for reporting intangibles; and defining the reporting entity (for example, identifying the reporting entity in a joint venture).

There are also many categories of standards that differ among major national standards, for example, revenue recognition. A convergence of opinion or approach will be required for these differences.

Despite the challenges of establishing Global GAAP, tier one is on its way thanks to the efforts of the International Accounting Standards Board (IASB),

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Tier One: Standards for Global GAAP

(continued from page 4)

which, with the support of national boards and international organizations, is working to make Global GAAP a reality. Of course, the IASB does not have the authority to force companies to use international standards. Therefore, the voluntary participation of national regulators is key. ■

For the six objectives of future Tier One financial statements, go to: <http://my.summary.com>

Tier Two: Industry-Based Standards

The second tier of the model is industry-based standards. Note that the standards under discussion here are global standards. Industries compete against counterparts from around the globe. In addition, how industries create value for shareholders and the knowledge that industries need to create that value vary widely from industry to industry. Therefore, country-based accounting standards are less relevant and helpful than international industry-based standards.

Global generally accepted accounting principles is a first step in providing international information for investors. However, supplemental information that is industry-specific — information that is both financial and non-financial — is also needed to evaluate completely a company's past performance and future prospects. Supplemental information could include pro forma earnings and free cash flow, neither of which is covered by any form of GAAP. Non-financial supplemental information could include information about intellectual capital or environmental pollution.

Standards Developed by Participants

A fundamental key to the success of tier two standards is that the standards should be developed by the industry participants themselves and should be voluntary, not regulated. Industry participants are not limited to companies; accounting firms, analysts and investors should also be involved in the development of these standards.

It may seem unrealistic to expect standards to be self-developed and self-regulated by companies and industries. However, the current evolution of standards for reporting pro-forma earnings offers an example of the power of voluntary collaboration.

Pro Forma: A Case of Self-Regulation

The reporting of pro forma earnings is controversial because there is no standard definition for what consti-

Information Moving Among the Tiers

Information that is developed for one of the tiers in the Three-Tier Model of Corporate Reporting can find its way to other tiers.

Suppose that Tier-Two industry-specific standards are applicable to a number of other industries, or that different industries develop standards that are similar. In each case, the Tier-Two standards could become Tier-One (Global GAAP) standards.

Tier-Three information — company-specific information — might likewise move to Tier Two. For example, one company might start measuring what it considers to be an important value driver. Other companies in the same industry might see the validity of the new value driver and emulate the first company, but use their own measurement methodologies. Eventually, investors might pressure for industry-wide standards for information on this value driver.

tutes such earnings. The business community has stepped up and expressed concerns about pro forma earnings. As a result, Standard & Poor's has attempted to specifically define what constitutes pro forma earnings, which are differentiated from what S&P calls "operating earnings" and "as reported earnings."

In another development, two professional associations, Financial Executives International and the National Investors Relations Institute suggested jointly in a press release that if pro forma earnings are used, they should be reconciled to GAAP. This suggestion was formally endorsed by the SEC.

Lessons

The discussion over pro forma continues. The point is that standards for reporting pro forma earnings are being developed voluntarily with various participants, offering a model for the voluntary and collaborative development of tier two standards.

The lessons that can be learned from this example — and other examples of voluntary collaboration in the development of standards — are the following:

1. Most initiatives begin with innovations introduced by individual companies.
2. The initiatives offer learning experiences that help identify the best measuring and reporting methods — methods that are then codified into a set of guidelines.
3. These initiatives involve broad constituencies, and rely on voluntary reporting to the guidelines.
4. These initiatives permit some form of independent verification. ■

Tier Three: Company-Specific Information

Tier three of the model consists of guidelines for company-specific information — which can range from corporate strategy and information on a company's value drivers to the company's internal control procedures and compensation policies. General guidelines for content and the format for reporting that content should be developed.

A Holistic View

Companies must offer investors a holistic view of the performance of the company. In other words, the various components of the company must be linked, and the company and its markets must be linked. Specifically, the company should demonstrate to stakeholders the links between marketplace opportunities and the company's strategy; between value drivers and measured results; and between management decisions and value creation.

At the heart of this holistic view of the company are the performance measures of the real value drivers of a company. What are those value drivers?

In a recent PricewaterhouseCoopers survey, executives ranked the following value drivers, which are listed from most to least important for creating value over the long term:

1. Product and service quality.
2. Customer satisfaction and loyalty.
3. Operational efficiency.
4. Current accounting results.
5. Product and service innovation.
6. Employee satisfaction and turnover.
7. Alliances with other companies.
8. Community involvement and environmental performance.

A listing of value drivers, of course, is of limited usefulness. The key is to develop a business model that shows, as mentioned earlier, the links between the value drivers and measured results.

Using the Guidelines

Excellent strategies, well-identified value drivers measured properly and a good business model is not enough to create value for shareholders. This information is a guide to action, but it must be used properly. An effective organizational design, rigorous risk management, sound compliance procedures and corporate governance that truly represents the interests of the company's various stakeholders are all key

to value creation. The disastrous results of lax corporate governance, for example, have been demonstrated in recent scandals.

Once again, in Tier Three, we find that success depends on the key elements of public trust: transparency, accountability and integrity. ■

Corporate Reporting: The Five Challenges

We close this summary with a look at the five challenges of transparent corporate reporting as required in the three-tier model presented above.

Challenge #1: Model External Reporting on Internal Reporting

The first challenge is to model external reporting on internal reporting. In other words, managers determine

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Executive Perceptions of Eight Value Drivers

Value-driver category	Important for creating shareholder value over the long term	Has a high impact on future financial performance	Use the measure in evaluation and decision making
Product and service quality	89	86	83
Customer satisfaction & loyalty	83	86	73
Operational efficiency	75	75	72
Current accounting results	71	62	81
Product & service innovation	62	60	54
Employee satisfaction & turnover	47	44	38
Alliances with other companies	20	22	17
Community involvement & environmental performance	11	8	11

Note: The figures record percentage of executives who agreed with the statements.

Corporate Reporting: The Five Challenges

(continued from page 6)

that they will report externally the same breadth of information that they use to manage the company internally.

Of course, not all internal information is relevant to external stakeholders. However, companies should begin with the assumption that they will report everything, and then determine why they should not report a certain type of information. If the reasons for not reporting the information are revealed externally — for example, the information would reduce a competitive advantage of the company — external stakeholders will understand and even applaud the decision.

Challenge #2: Determine the Information That Stakeholders Need

The second challenge of transparency is to determine the information that stakeholders need. In addition to identifying this information, management must provide this information in a format that is as useful as possible.

Information gaps — the gap between what stakeholders believe is important for them to know and what companies are willing to provide — exist in nearly every industry. For example, while banking firms are upfront about their market share, earnings and product innovation, they do not provide stakeholders with such important information as market growth, customers and quality of management. Telecommunications companies are especially reticent. Information gaps exist in their areas of market growth, market share, corporate strategy, cash flow, segment information, product innovation, customers and quality of management.

How do you know what information stakeholders believe they are missing? The answer is simple: You have to ask them, either through your company Web site or through surveys.

Challenge #3: Report Relevant Information from External Sources

The third challenge of transparency in corporate reporting is reporting relevant information from external sources. Internal financial information systems cannot provide all of the information desired by stakeholders. External information is needed to explain how the company is performing against industry trends or specific competitors, for example. It's easy, for instance, to trumpet a 10 percent market growth in the past year; the information is more useful, however, when one knows that the industry average was 13 percent growth!

Challenge #4: Report on the Real Economic Entity

The fourth challenge of transparency is reporting on the real economic entity. The Enron scandal illustrates how unscrupulous managers can determine self-serving

In Search Of The Real Economic Entity

What is your company's "real" (as opposed to "official") economic entity? The perimeter of your business isn't as clean and straightforward as you may believe.

For example, a shoe company that outsources its manufacturing might say that those manufacturing partners are not part of the economic entity of the company. Technically, it may be correct, since the manufacturing subcontractors are not owned by the shoe company. However, as one shoe company discovered, a company's brand and reputation can be severely impacted by the activities of a subcontractor.

In addition to subcontracting to low-cost manufacturers, here are some other examples of how a company can expand the borders of its real economic entity:

1. Subcontracting non-manufacturing functions.

For example, high-tech companies will subcontract day-to-day operational activities so that they can lower fixed costs and focus on product development and marketing. However, performance information on these subcontractors is as important to investors as if the firms performed these functions in-house.

2. Selling through distributors. Beverage companies often don't own their distributors. The financial performance of these distributors, however, is still vital in assessing the performance of beverage companies.

3. Outsourcing information technology. A number of companies — especially dot.coms — can outsource their information technology functions to application service providers (ASPs). ASPs, however, became so dependent on these outsourcing contracts, that when the dot.coms went under so did some of the ASPs (much to the dismay of the ASPs' other customers). Do you know who your partners' partners are?

4. Outsource research and development. Large pharmaceuticals, for example, might fund small biotechnology firms to conduct initial research. Information about these smaller firms — including capitalization, intellectual property rights and marketing rights — is important in assessing the pharmaceutical company's return on capital.

definitions of the boundaries of the entity subject to reporting requirements (thus hiding other transactions "outside" the boundaries).

However, determining the real economic entity is not easy; direct relationships with partners can come in many forms, and indirect relationships can be as important as direct partnerships.

The independent board of directors is probably the

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Corporate Reporting: The Five Challenges (continued from page 7)

best decision maker on this issue; it has less self-interested motives to play games with the boundaries than managers might have. Of course, the board must know all the relevant relationships in which the company is involved and understand the dynamics of the value chain of the business.

Challenge #5: Model External Reporting on Internal Reporting

The fifth and final major challenge of transparency is weighing the risks and costs against the benefits. While management may exaggerate the costs of transparency and underestimate its benefits, there are certain disclosures that, in the balance, would be detrimental to the company. There is no formula for calculating the trade-offs between costs and benefits of transparency. Because it is a judgment call, that judgment should be left, once again, to a fully informed board of directors.

When deciding whether or not to disclose information, two principles apply. The first is openness. Disclose as much as possible, and have a clear reason not to disclose information. The second principle is consistency. If you decide to disclose information, continue with the practice in good times and bad. ■

XBRL: Enabling Information Quality, Speed and Usefulness

Reforming corporate reporting does not only involve the content of the information conveyed by the corporate reporting supply chain. The format in which that information is presented is equally important.

In the past, there was no choice in format: It was either paper or nothing. Even in the electronic age, corporate reporting is often no more than electronic versions of paper (for example, the PDF versions of annual reports found on corporate Web sites).

Electronic versions of paper information have the same limitations as original paper documents. For example, if you want to take data from a report and put it into the spreadsheet, you need to manually enter the data in your spreadsheet application — whether you're pulling that information from a paper report or a PDF file. This is problematic not only because it takes more time, but also because it opens a window for errors.

Another problem with information on paper or quasi-paper computer applications is that the readers will get little help in understanding the context of the document — or verifying the information. What you see is what you get — and what you get may not be reliable.

Publishing information on the Internet does have

some advantages; quick access is the most obvious of these advantages.

However, investors and other stakeholders can benefit from a more flexible and complete information transmission system provided by a new Internet-enabled platform called Extensible Business Reporting Language (XBRL®).

XBRL can dramatically improve the quality, speed, usefulness and completeness of the information that companies provide to the public. By tagging every piece of information with a contextual description, XBRL enhances the transparency of the process, and allows investors to validate the reported information in accordance with prescribed standards, such as Global GAAP at Tier One and industry-based standards at Tier Two.

How XBRL Works

XBRL delivers corporate information — or more accurately, data — along with identification tags that allow the computer to place the data in context.

For example, in the past one computer might send another computer data on a company's \$5 million in revenues by transmitting the number 5,000,000. The receiving computer would have to have already been programmed to recognize that number as revenue and to put it in a predefined revenue bin expressed in dollars. With XBRL, no preprogramming is necessary. The data — in this example, the number 5,000,000 — comes with tags that say, "This number is revenues, as defined by Global GAAP number 18, measured in U.S. dollars for a specified period of time for this unique company." The receiving computer allows the information to flow automatically and seamlessly into the right bin.

Investors and analysts can view and use that information as they wish. For example, an investor might automatically compare a company's revenue to its profit, to prior-period revenues or to another company's revenues. Without XBRL, the investor would have to manually take the information and input it into its own analytical software program.

Of course, XBRL is not limited to Global GAAP information. It can tag any kind of information, including the nonfinancial, industry-specific and company specific information at Tiers Two and Three. Users can also capture information anywhere on the Internet and reuse it — including, as in the example above, in an investor's analytical software.

Content is important, but format can be just as valuable in making the information relevant and useful. The XBRL format is an important enabling technology for the future of corporate reporting. ■

For information on a tool to help organize financial information, go to: <http://my.summary.com>

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Retirement 101

The Reasons and Remedies Beyond America's Failure to Plan

Review by James Brumley

Millions of people in the United States are going to fall short of their retirement needs ... and not just in terms of money. It's not a topic many of these people are interested in discussing, as it may cause various levels of distress, even anxiety. However, aversion to addressing retirement planning *now* sets up certain — and greater — worries later in life.

As Lee Eisenberg points out in his book *The Number*, it doesn't have to be that way. All that's needed is some attentive and honest thought about what one wants in life. In that light, *The Number* is less about financial or investing "how to," and more about life planning. And better life planning usually results in stronger financial positions once retirement begins. Simply put by Eisenberg in the prologue: "This book is about money, but ultimately it's about the life you want, the life you don't and the costs of each."

What Do You Want From The Second Half Of Life?

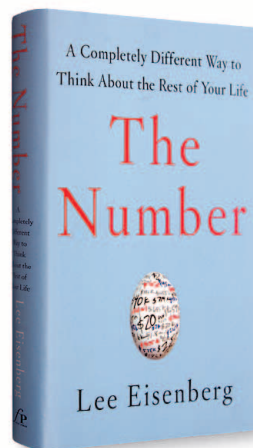
One of the most refreshing components of this book is rooted in the fact that Eisenberg, although fully qualified to write on the subject, is not a financial planner or investment advisor. Free of all the technical jargon and formulaic approach one might find in books stacked near this one in the library, the reader is spoken to in plain English. It's easy to understand and, more importantly, gets straight to the point. *The Number* is about realistically defining a specific dollar amount a retiree will need to save when he or she finally leaves the workforce. However, relatively few pages address the calculation of that figure: For Eisenberg, there are more important things to discuss.

Why? Because Eisenberg believes a specific dollar amount is secondary to the more burning issues every retiree will eventually face. Using case studies and introspection, Eisenberg walks a reader through all the tough questions that should be asked *before* retiring, not after. Yes, at the end of the day, he says, the amount of money you have determines what you can do in retirement, but no amount of money will actually make you happy. *The Number* could be considered groundwork for making sure both pieces of the puzzle are in place.

Which Type Of Person Are You?

Eisenberg establishes four distinct personalities — Procrastinator, Plucker, Plotter and Prober — one of which will apply to every reader. It's a clean, thorough classification system that includes characteristics of each type to help the reader identify which of the four he or she may be. For each type, Eisenberg includes the *modus operandi* as well as a planning profile, details which set his book apart from others.

When considering the Pluckers, Eisenberg suggests that this group doesn't necessarily think through a retirement goal but rather plucks one randomly out of the air. He identifies the plucker's *modus operandi* as guessing and sums up the group as scatterbrained. The other groups have different but equally problematic flaws, and each is similarly supplied with a summary description. Probers or "right-brained" types, for example, may be subject to over-fulfillment later in life, while Plotters or "left-brained" people risk losing sight of what's important in life because they're too busy with



THE NUMBER
by Lee Eisenberg
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“In Eisenberg’s view, peer pressure, on a societal scale, leads to what he labels ‘Debt Warp’ — a condition where values about avoiding debt are eroded by a barrage of consumption encouragement.”

processes and information. Eisenberg’s final group, the Procrastinator or “brainless” type, appears to be at the most risk.

Though Eisenberg does not immediately tell why the personality types are important, the four basic types of people are revisited with examples in later chapters. Each example adds another layer of depth to the personality type, and by the end of the book it should be easy for readers to determine which they are. In the process, Eisenberg suggests they’ll also learn how this can help them improve the rest of their lives.

Debt Warp

Eisenberg boldly identifies what may be the biggest reason most people ultimately fail to reach their dollar goals: debt. He then proceeds to explain how we get there in the first place. It has little to do with financial controls and budgeting, he says, asserting that the culprit behind overspending is the attitude largely imposed upon us by our society.

In Eisenberg’s view, peer pressure, on a societal scale, leads to what he labels “Debt Warp” — a condition where values about avoiding debt are eroded by a barrage of consumption encouragement. Most consumers may not even realize it, he says, because they’re desensitized. Magazines, television, retailers and other sources inundate the public with easy ways to get fulfillment now, while consequences are never mentioned. Eventually, the consequences — and how they might affect the future — don’t even occur to the spender.

Eye-Opening Stats

Eisenberg supports his position with a barrage of statistics. He notes, for instance, that the richest 1 percent of Americans carry 6 percent of the

nation’s debt. Simultaneously, the poorest 90 percent of Americans carry 70 percent of the total credit debt. If that sounds equitable, keep in mind that the richest 1 percent of Americans also control many times more than 6 percent of the total wealth. Excessive debt, mostly due to guilty pleasures, is keeping the “number” needed for a successful retirement out of reach for most consumers.

Eisenberg excels at using statistics for effect, not filler. He never allows an elaborate record of facts to slow the pace of the book, but rather offers select stats to shock the reader to full attention. For instance, some may be surprised to know that 80 percent of all employees eligible to enroll in a work-sponsored retirement plan do, indeed, contribute 5 to 6 percent of their pay to such plans. While that degree of participation might seem to contradict the premise of Eisenberg’s book, the fact that most workers will still be unable to retire with enough assets despite a high degree of 401(k) participation is one of the author’s key points. In other words, although many people take the right steps, they are still making grave errors, such as improper asset selection, extreme debt and misplaced priorities.

Even harder-hitting is his comment that while one out of two people may question whether their retirement will be as comfortable as their working years, this leaves 50 percent of retirees not saving enough. And four out of 10 workers save absolutely nothing for retirement. Eisenberg notes that the number of Americans saving for retirement has not increased in the last three years; only 18 percent of workers have more than \$100,000 in accessible retirement assets.

Debt statistics are also strategically placed throughout the book. The Federal Reserve’s decision to lower



interest rates in the early 2000s, for example, made credit “easy” to come by, exactly as intended. But Eisenberg’s research explains a grim result of cheap credit: Between 2000 and 2006, automobile loans and credit card debt in the United States increased by 33 percent, and mortgage debt increased by 50 percent.

Eisenberg uses such disturbing evidence to incite his readers to a direct and honest evaluation of their own situations. But, despite the punch provided by such statistics, there are few references to where the data originated. While this omission does not reduce the book’s strength, credited sources would have given Eisenberg’s effort greater impact.

Eisenberg’s Uncertainty Principles

In keeping with the best of such books, Eisenberg offers something unique — in this case, the impact of uncertainty on long-term financial health. His six “Eisenberg Uncertainty Principles,” detail the reasons most workers avoid planning for the future. They include:

1. The uncertainty that results from living in a society and culture so steeped in the moment, awash in debt, that there’s little social or peer pressure to get one’s financial house in order.

2. The uncertainty and lack of motivation that comes from not knowing how money works.

3. The uncertainty caused by knowing that old retirement support systems are withering away.

4. The uncertainty caused by the immense cloud that hangs over future retirement benefits.

5. The uncertainty that comes from failure to see the larger picture in all of the above.

6. The uncertainty over what truly matters at the end of the day.

These six principles are the core components of his book. Most are illustrated with examples and case

studies. Eisenberg’s first uncertainty principle addresses his belief that our society is focused almost entirely on instant gratification, with no social or cultural encouragement for anyone to make smart money decisions. Another principle he addresses is the likely or perceived failure of current retirement-income institutions. Through his use of case studies, statistics and other examples, Eisenberg encourages the reader not to count on questionable sources of retirement funds, since they really might not be there when the time comes. Instead, he stresses that each person’s financial destiny is in his or her own hands.

Eisenberg’s other four principles are of the same scope, and have the same degree of impact on the way we each think about our own number. And to his credit, although he doesn’t specifically label the examples so clearly in the latter part of the book, Eisenberg does offer convincing evidence that his six uncertainty principles are at the heart of the failure-to-plan problem.

Ten Simple Investing Rules

What money book would be complete without a list of 10 things?

Eisenberg’s list includes 10 investing rules — commandments as he calls them — that are applicable to anyone looking to reach their target number in life.

Some of his commandments are obvious, and none will be a surprise, even to a non-investor. For instance, he suggests that investors should mirror the patience of a nest-ing hen. Another commandment is simply to avoid fees and commissions.

Any investor knows, however, that

“Eisenberg’s first uncertainty principle addresses his belief that our society is focused almost entirely on instant gratification, with no social or cultural encouragement for anyone to make smart money decisions.”



following simple long-term rules can be difficult when things don't work out as expected in the short-term. Eisenberg addresses this with four reasons why investors can't stick to their own rules. One of these is simply the abundance of choices for consumers. When forced to pick between stocks or funds, full-service or self-service, aggressive or conservative styles, an investor can be overwhelmed. The easiest choice of all, suggests Eisenberg, may be to do nothing. Of course, doing nothing would violate several Eisenberg principles — especially the failure to plan.

The 'Sweats'

In his chapter "Night Sweats," Eisenberg taps into what he believes are nagging doubts his readers have about their dwindling or under-performing retirement accounts. "It's 10 p.m.," he writes. "Do you know what your number is?" Anyone who has ever been startled by the dire thought of retiring poor can relate. Here, Eisenberg goes to the financial experts, beginning with a description of his visit to the Boston offices of Fidelity Investments, "the big player" in the financial services industry, as he calls them.

The reader walks with Eisenberg through Fidelity's doors, feeling the "nip" of air conditioning after the heat of the streets — an amusing commentary in itself, intended or not. Eisenberg passes on the chance to give us a peek at the big player's working environment, but makes up for it with snippets of his interview with Fidelity COO Bob Reynolds. A 20-year veteran of 401(k) management strategy at Fidelity, Reynolds tells Eisenberg that in his view, most Americans' approach to retirement makes it "the biggest do-it-yourself project ever." A Fidelity white paper on the subject states that, even when Americans finally do address retirement issues, they typically "play it by ear."

Eisenberg doesn't spend too much time with

Fidelity, but he allows enough in from this respected source to bolster his argument without sounding like a commercial for the financial services industry.

Downshifting

The concept of downshifting may be Eisenberg's ultimate lesson. As he describes it, downshifting is the fundamental change or adjustment a person should make once they retire. It's a clever and appropriate choice of words. While Eisenberg says the general expectation for an under-funded retiree might be a lower standard of living, in *The Number* he makes it clear that the so-called "standard" is a construct created by others and may have nothing to do with actual quality of life. He further argues that in the second half of life, money isn't as important as fulfillment — a duality that most workers and retirees struggle with constantly.

The book makes a powerful point about the changing perception of time and priorities as people shift closer to the end of life than the beginning. To Eisenberg, the point of retiring is to enjoy laughter, friends and giving back; he wants to make it clear to his readers that money in itself is not going to be enough.

Deliberately Different

Should an investor expect to read *The Number* as a "how to" resource and magically calculate the precise dollar amount he or she will need to retire, they'll be in for a surprise, albeit a pleasant one. Eisenberg's book is one of the few that deals with the more important "why" issues, such as why decisions aren't made sooner to ensure a successful retirement. In many respects, *The Number* should be a first read for a new investor. It is an easy-to-read work, delivered in a believable voice from an author who has no hidden agenda. Even moderately experienced investors, as well as anyone who has yet to map out a financial plan, will enjoy this fresh look. ■

The author: Lee Eisenberg is a former editor in chief of *Esquire* magazine. During his 20-year tenure, *Esquire* won National Magazine Awards in several writing and design categories. Most recently Eisenberg served as executive vice president and cre-

ative director at Land's End. A contributor to *Money* and *Fortune* magazines, Eisenberg is also the author of *Breaking Eighty: A Journey Through the Nine Fairways of Hell*.

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Give to Get to Give

Randy Dorcey

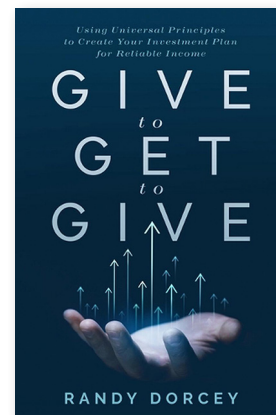


Executive Book Summaries®

Give to Get to Give

Using Universal Principles to Create Your Investment Plan for Reliable Income

by **Randy Dorcey**



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THE SUMMARY IN BRIEF

“Advice is cheap and easily given. Counsel comes from a position of experience and expertise. When you are about to make a decision, it’s easy to find many people who will offer you advice. But those who can provide strong counsel are harder to find.”

The book *Give to Get to Give: Using Universal Principles to Create Your Investment Plan for Reliable Income* offers a crystal-clear strategic financial counsel that breaks the dangerous myths many financial gurus offer today. It, quite literally, drills the most critical principles of creating a fully funded living trust into the readers’ minds.

By weaving his delightful humor with deeply serious financial strategies, author Randy Dorcey ensures we are fully informed on how estate planning works, how to prepare for future financial catastrophes, how not to put all your dollars in one basket, why having a trusted financial counselor is critical, how you can reduce the amount of money you give away in taxes, and how to truly create financial freedom for a smooth retirement journey.

IN THIS SUMMARY, YOU WILL LEARN:

- How to create a reliable investment plan for your retirement income.
- How to avoid myths surrounding financial planning for retirement.
- How not to let the so-called complicated nature of investments overwhelm you.
- Why having an experienced and trustworthy financial counselor is critical.

Introduction: Some Advice About Ice

As a budding musical prodigy in kindergarten, I was given the opportunity to introduce our group's live performance at the Thursday PTA meeting. My speech went as follows: "Parents and teachers, now presenting, the Kindergarten Band!"

I practiced endlessly to get my speech right but my elder teenage brothers, faced with the irresistible urge to get into mischief, had other plans for me. They "advised" me to give the following speech instead, "Lay-dees and gentlemen, take my advice; pull down your pants, and go slidin' on the ice!"

So, when the day of the performance finally arrived, my sweet little kid's mind was trying hard to determine which speech I was supposed to deliver. Thankfully, I ended up choosing to follow the counsel of my mom and teachers over the advice of my brothers. And this distinction between counsel and advice is one I have continued to affirm for thirty years in the finance industry.

So, the old guy knows stuff. While he may have momentarily blown it as the kindergarten bandleader, he didn't cave to sibling pressure and sagely intuited to follow his own instincts. Those instincts served him well, allowing him to serve others in the capacity of a retirement income growth counselor rather than the factory-milled or gimmicky, slick Rick financial advisor. That counsel starts with "Pay Yourself First" so you can give to others, which ultimately circles back to giving to yourself.

The universal law of "give to get to give" is all about offering a percentage of your time, energy, and resources when you have little to invest. And then as your income and investments increase, you can continue to give back to others.

Chapter 1: Name Those Cows

The purpose of a farm cow is to provide dairy, and ultimately, meat. One summer, I welcomed two nice calves into my hobby farm, and of course, being babies, they were endearing. Everyone around warned, "You're gonna get attached and fail to treat them as farm animals." So, I decided to name them "Whopper" and "Big Mac." The purpose of those calves was known from the get-go, and christening them as I did reinforced to all, especially me and my children, what that purpose was. Critical to your financial success is understanding that not understanding your actions can be even more damaging than not knowing financial basics in the first place.

Freedom is the endgame you can only win if you start and allocate something to savings now. If your immediate reaction to reading those words was "I don't have anything extra to budget for savings right now," you're among those especially in need of reading them. Remember, the stress of living paycheck to paycheck vanishes once you have that \$5,000 emergency cushion. Understanding your actions allows you to adeptly modify your behavior, such as naming your cows, so you can realistically attain control of your finances and thus your financial freedom.

Chapter 2: Stick with Your Whoppers and Big Macs

"Don't put all your eggs in one basket" applies just as well in the twenty-first century as it did in the seventeenth century.

Unfortunately, this is what often happens when one swallows what is being passed off by financial advisors and investors at the Buffet of Orchestrated Optimism: one financial basket for all your investments.

Much of what bombards you in terms of "financial news," whether that be through financial advisors, television news analysts, the general public, or the internet, is not objective news or objective information. The majority is spin-biased rhetoric and disguised advertising, all ringing with pronounced optimism. Never drink the Bud Dry without asking why first.

By investigating the why, you can determine what "specialty" is really being sold to you and the reason it's being sold.

Chapter 3: Eggs, Big Macs, and Whoppers

"Don't put all your eggs in one basket," is not only a quaint maxim but also excellent retirement income advice.

Let's say you start with eight eggs in your basket and trip on your way out of the henhouse, and crack four eggs. From the investment perspective losing four eggs accounts to 50% of your basket. So, if your basket is worth \$100,000, you lose \$50,000. You now need to double the remaining \$50,000 to get back the original \$100,000. But here's the kicker: earning 50% only gets you back to \$75,000, so you're still out \$25,000. Which means you really have to earn back at 80% just to break even!

A common error when assessing the cost, benefit, and risk

Your retirement plan is more like a rolling stone than a watched pot. It will gather no moss if it's watched, and a mossy retirement is as bad as it sounds.

of lining one's portfolio with stocks is the omission of this build-back. Another common mistake is the failure to incorporate the inflation factor.

The even more important thing to remember is playing catchup isn't the game you want to be in when retirement is the goal. Cost/benefit and risk assessment should factor in the build-back. A 25 percent loss takes 33 percent to make up for; that's a lot when you have to eat.

Chapter 4: The Monetary Value of Trust and Trusting There is Always Enough

Active management is an important concept when thinking about your financial future. Your retirement plan is more like a rolling stone than a watched pot. It will gather no moss if it's watched, and a mossy retirement is as bad as it sounds. If left on the stove unattended, it will, no doubt, boil, but if you've ever neglected a boiling pot, you appreciate that it eventually burns to nothing.

Mixed metaphors aside, you get the point: active management filters out corporate risk, inflation risk, and interest rate risk – all crucial to your financial freedom.

Short of a surgeon or a pilot, and maybe an attorney, at no other time and in no other way does one so completely turn the reins of well-being over to another as one does when it comes to financial advisors and one's retirement income. While pro/con analysis, qualifications, pedigree, and experience may seem like they're driving your selection, the truth is, it's all a matter of trust. Make sure you trust on that most important inner level whoever holds the reins to your financial future.

And in the most unforeseen ways, if one just trusts in trust, in giving to get to give, it works. It just does.

Chapter 5: The Fun in Trusting the Magic Elixir Mixer

Attaining your financial freedom is only the first part. The second part is maintaining that freedom once you are in retirement. Many investors believe that increasing income requires taking on more risk. But risking your retirement income, especially when one is in retirement, is just wrong.

A common investing mistake is to think growth and return are the same thing. When one invests for income instead of growth, one wants to utilize vehicles designed to significantly reduce volatility. Growth quickly turns to loss when a crisis hits. Growth is actually just one component of return, and income is the other. When investing for income, the total return comes from two components: income plus growth.

So, the best way to continue growing your portfolio organically is by strategically reinvesting the income you don't need into other more conservative vehicles. Stocks, however, are not the first-choice investment tool for either part one or part two of financial freedom. They are not contracts to anything. They're more like tickets to a roller-coaster ride that in the end may leave you puking alone in the amusement park.

Chapter 6: Growing Your Crop

Growing your portfolio during your retirement years isn't altogether different from growing it to get you there. The "give to get to give" principle still applies. But you do need to make sure you don't outlive your money.

Retirement is about more than just money. And a satisfying retirement involves more than just adequate savings. It also entails mental and physical well-being, as well as interesting leisure activities, creative pursuits, and self-discovery.

You can supplement retirement savings and help stretch what you've already socked away by working a little longer, or part-time in retirement, at a profession or hobby you love.

Write down exactly what you want your life to look like during retirement and, either alone or with the guidance of the right financial counselor, develop a plan to make it happen.

Chapter 7: More Growing with Some Knowing

Unless you're among a select few, such as retired public service employees, you're not going to get a monthly paycheck from your employer for the rest of your life. But that doesn't mean a guaranteed source of lifetime income is out of your reach. There's an estate planner's tool called an annuity, which allows you to create your own pension of sorts. And you can buy one even during your retirement years to generate some of that retirement income.

But because there's more than one type of annuity with multiple variables, annuities tend to be off-putting. However, complicated doesn't always mean bad. And in the retirement income arena, complicated can even mean money. When words like complicated and financial get used in the same sentence, that usually gets interpreted to mean annuities, so what you should get out of this chapter is: don't be afraid of annuities.

Annuities are like everything else: some suit their owners well and do their job, while others suit very few people. While making sure you trust whoever is making the pitch for whatever investment tool is being offered is obviously a golden rule, the rule holds particularly true when it comes to annuities. Make sure you trust, in terms of knowledge and financial acuity, whoever is selling the annuity. Your old-school chum who does financial planning part-time after completing a few webinars during lockdown may not be the right person.

Finally, always be slamming Sam. Let me explain this using a farming example. It is critical that your retirement income, your "farm," serve you solidly throughout your retirement. Slamming Uncle Sam before he slams you is key. And by slam, I simply mean employing the tax code in a way that serves you. To do this, you need more than just a financial advisor. You need a retirement income counselor who specializes in estate planning and literally makes it their business to know the tax code so they can help you shield as much as possible from Uncle Sam.

Chapter 8: There's Giving and There's Getting Got

This was, admittedly, a tough chapter in terms of financial concepts, so if you didn't quite follow all of it, don't worry about it because What You Should Have Gotten is rather simple: one can never be risk-free, so beware and be aware. This applies in horseshoes, hand grenades, and, dagnabit,

the deceptively named "risk-free" interest rate.

Chapter 9: When the World Changes

Not to be overdramatic or to repeat the mantra we're all rather tired of hearing, but sometimes reality is best met head-on. COVID-19 has changed the world, which means everything in it has changed, and the fallout not only permeates our current daily lives but will also continue to impact our futures in ways we have yet to appreciate.

What anyone thinking about a retirement income strategy should most definitely appreciate, however, is that these changes have already impacted, and will continue to impact, one's retirement.

Accepting this truth and pivoting, whatever pivoting may mean to an individual, is critical. Whether one is in the accumulation years and looking forward to a financially worry-free retirement or is already living off the sweat of their working years, an ostrich-head-in-the-sand or delayed approach can be fatal to one's retirement.

Conclusion: The Universal Principles of Giving

As we bring this book to a close, it's time to think back on some of the lessons highlighted.

The first of these is to remember the difference between advice and counsel. Advice is cheap, whereas counsel comes from experience and expertise. Always name your cows! Earmark the percentage of your income that will go toward investment, and then stick with that process. Don't lose sight of what that money was for, and do not ever eat your investment seed corn.

Find a financial counselor who will actively manage your investment. Do not settle for riding the waves of one financial crisis to the next. Instead, be proactive and work with individuals who have your best interest at heart. Grow your crops. Do not fear the complicated nature of investing, and do all you can to "Slam Sam" by reducing the amount of money you pay to the government in taxes. And when global catastrophes, such as pandemics, emerge, stick with your game plan and work with a trusted financial counselor to actively navigate your path forward.

And in the end, always give to get to give!



Dr. Randolph "Randy" B. Dorsey is a practicing estate planning specialist. In 1988, Randy became the founder of Dorsey and Associates, which has evolved into Dorsey Financial, LLC. Randy has dedicated the last thirty years to educating his clients on how to use their money to achieve their life's goals in retirement and beyond. As a public speaker, Randy provides Living Trust and Trust Funding legacy presentations for groups of all kinds and sizes. He specializes in asset preservation, lowering taxes, understanding social security maximization as well as helping to protect your estate from nursing home depletion.

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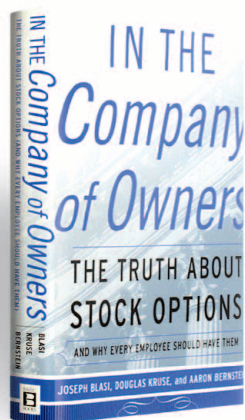
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In the Company of Owners

Joseph Blasi, Douglas Kruse, and Aaron Bernstein

SOUNDVIEW Executive Book Summaries®

FILE: EMPLOYEE OWNERSHIP



The Truth About Stock Options (And Why Every Employee Should Have Them)

IN THE COMPANY OF OWNERS

By Joseph Blasi, Douglas Kruse,
and Aaron Bernstein

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THE SUMMARY IN BRIEF

Recently, stock options have gotten a bad reputation as the runup in the stock market during the 1990s allowed some corporate executives to pursue unethical strategies to pump up their stock and cash in on their options, while employees saw huge potential fortunes disappear overnight. The corporations, their employees, and investors all appeared to get a raw deal from options. The problems were a consequence of abuse of stock options, not the concept itself. Stock options have typically been concentrated with top executives while exposing lower level employees to risky 401(k) plans stuffed with company stock. The authors estimate that the top five executives of the 1,500 largest U.S. companies received \$18 billion in option profits in 2001. But are they really providing enough value to overcome the dilution their shares cause? In *The Company of Owners* shows how and why stock options and the risk of ownership should be given to most of the work force.

What You'll Learn In This Summary

- ✓ The history of shared ownership between labor and owners.
- ✓ How stock options became a necessary tool for recruitment and retention for high-tech companies in the 1990s.
- ✓ How high-tech companies use options differently than traditional firms.
- ✓ How giving out options every year improves the return for employees and management.
- ✓ How shareholders profit from employee options despite the dilution of their shares.
- ✓ How traditional corporations can use the high-tech model to take advantage of the benefits of partnership capitalism.

IN THE COMPANY OF OWNERS

by Joseph Blasi, Douglas Kruse and Aaron Bernstein

— THE COMPLETE SUMMARY

The History Of Partnership Capitalism

Although there had been experiments in sharing profits for almost a century, it was the high-tech industry of Silicon Valley that found the right combination of cultural and financial incentives in stock options that have become partnership capitalism.

It All Began With Shockley

Nobel Laureate William Shockley left AT&T in 1956 to start Shockley Semiconductor Laboratories in Mountain View, Calif., because AT&T would not share royalties from patents based on his ideas. He recruited some of the country's finest engineers and physicists, but he was an arrogant manager who treated them no better than AT&T had treated him. In 1957, Robert Noyce led eight dissatisfied employees to pool their brainpower and found a company based on knowledge.

When they acquired funding with the help of Arthur Rock, they set up an unusual arrangement. Each of the eight scientists received 10 percent and Rock's banking firm got 20 percent, while Fairchild Camera and Instrument lent the group \$1.5 million for an option to buy the company for \$3 million. The scientists insisted on a culture that showed them the respect Shockley did not. There were no titles, dress codes, or reserved parking spaces, and everyone sat in an open room.

Valuable Knowledge Workers

After selling Fairchild Semiconductor in 1959, Noyce realized that knowledge workers would become increasingly valuable and would need ownership for motivation. But Fairchild only reserved stock options for top management and refused to change. Noyce and Gordon Moore left Fairchild to found Intel. Fairchild and Shockley lost much of their best talent to upstart competitors while Intel went on to become one of the most valuable companies of all time. The new corporate model gave intellectual and financial credit to workers whose creative talent contributed to the wealth of the company and proliferated through startups founded by former Fairchild employees. By the late 1980s, more than 100 companies could be traced back to Fairchild.

Partnership capitalism relies on an ownership

stake and a nonhierarchical culture of collaboration. It mirrors the structure of the Internet — the technology that set the stage for a new corporate model.

There were two kinds of Internet companies: Those that focused on selling goods over the Web and those that produced the infrastructure of the Web. The former mostly disappeared after the crash of 2000, but the latter went on to accidentally embrace a new model of management.

The explosion of Internet companies made an already tight labor market even worse. The talent wars found companies outbidding each other for the best employees and pressuring Congress to expand visas for skilled immigrants. Without cash or profits, Internet startups used stock options to compete. This involved employees in decision making, and gave employees opportunities to affect their stake in wealth-generating capacity. Stock options became the industry norm, and even after the crash, companies had to give out stock options to stay competitive.

A Radical Shift in Relationships Between Managers and Employees

The idea took off so quickly because in the consistently faster cycle time of the industry, **innovation, rather than production, garnered wealth.** The companies needed brainpower as fast as they could get it. Even shareholders were willing to dilute their ownership because they believed in the new partnership system.

There was a radical shift in the relationship between

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The History of Partnership Capitalism

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managers and employees. The new model:

- **Spurred innovation and performance from the bottom up.**
- **Made employees more likely to work as teammates than competitors.**
- **Made employees more likely to put creative abilities toward the company's interests rather than fulfilling their own career interests.**
- **Blurred the lines between worker and management, allowing employees to take problems and issues straight to top management.**
- **Decreased turnover.**

A Successful Employee-Centered Culture

Cisco, like many other companies, was able to set up a successful employee-centered culture that worked through tough times. With every new company acquisition, Cisco expanded its generous stock plan to new employees and integrated them into its collaborative culture with special orientation teams. Even when the company's stock dropped 70 percent in mid-2001, the culture remained. New stock options were issued at the lower price, and employees did not abandon the compa-

Netscape's 200 for 200 Program

In 1996, Netscape CEO James Barksdale needed to motivate employees for the new strategy to license software so buyers would pay fees that rise with the number of users. He set a goal of 200 design wins (i.e. convincing large firms to use their software designs) by June 30, 1997. Everyone throughout the company would have to work hard. Rather than offering a set \$500 bonus to everyone, he said that if Netscape reached its goal, every single employee would get options to buy 200 shares.

The company cafeteria had a 5-foot thermometer sign with the mercury designating design wins for every employee to see. Barksdale told employees, "When the sales force is out in Paris, and they call back to headquarters and say they need help to make a sale, I want the receptionist who answers the call to know how important it is to hook the sales person up immediately to the engineer who's got the little piece of code that will make the difference."

With effort from everyone and constant updates through the months, the company reached 200 wins by June 30. They sold \$135 million in software, an 80 percent increase over the same period the previous year, and every employee was 200 shares richer.

Toys 'R' Us Shows CEOs the Options Jackpot

One of the first huge executive option payouts went to Charles Lazarus, founder of Toys "R" Us Corp. He sold the toy store chain in 1967 for \$7.5 million, but it foundered in subsequent years and sank into bankruptcy. When it emerged in 1978, Lazarus returned and set aside 15 percent of the company's shares for executives and store managers in the form of stock options. Under his management, the chain became the country's top toy retailer. By 1987, the company was worth \$5 billion.

That year, Lazarus earned a bonus of \$3.3 million, which was large by the standards of CEO pay at the time. His options payoff, however, was \$56 million. Norman Ricken, the company's president, got \$11 million, and many of the store managers also pulled in large windfalls. Suddenly, other CEOs across the country woke up to the stock option bonanza.

ny, but chose to stay and fight. Options withstood the slump because employees didn't have to pay for them with their own money; many workers still made money from options despite the crash; and Cisco continued to give out options after the slump, still tying employees to the company.

For centuries people have used options that allow owners and investors to protect themselves against extreme outcomes. Property owners give up a portion of potential profit in exchange for sharing the risk of catastrophic losses. The option holder gets the rights of partial ownership with a much smaller investment, and has no obligation to exercise the option, so loss is limited.

The Separation of Ownership and Control

The rise of publicly traded companies in the 1920s and 1930s saw the separation of ownership and control, and shareholders wondered if CEOs would cheat them. Options were a controversial solution designed to keep the executives honest. The intellectual battle over options lasted for decades. Was it appropriate to give away equity? How should they be taxed? Were stock price increases because of general market increases or individual executives? In 1976, Congress essentially legislated stock options out of existence by making employees go back to paying the standard personal income tax rate on option profits.

In the early 1970s, the Black-Scholes pricing system was developed, and the Chicago Board of Trade opened to trade options on the shares of public companies. Both

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The History of Partnership Capitalism

(continued from page 3)

events increased confidence in options and helped them become mainstream for executive pay. In the 1980s, mergers and layoffs were holding down worker pay, while people complained that CEOs got more and more. Options for senior managers made it more difficult to compare their amazing wealth with workers'.

CEOs did not give out options to everyone. They felt only top executives were covered by the 1934 New York Supreme Court ruling that designated employees "whose labor, skill, ability, judgment and effort have made profits available" as those who deserved options. Corporate America began to spread options down the hierarchy, but only a tiny percent came close to high-tech companies. Though companies talked about workers being their most vital asset, they did not back this up by sharing the risks and rewards of ownership. ■

For Additional Information about the mechanics of stock options, go to: <http://my.summary.com>

How High-Tech Firms Do It

There is no precedent in modern American history for how Internet high-tech firms have granted ownership to their employees. The research in *In the Company of*

Portal's 350 Millionaires

Even after the dot com crash, employees who had received options when they were priced ridiculously low collected \$25 billion in profits in 2000 and 2001 — an average of \$125,000 per worker.

Portal was an ISP founded in 1985 that shifted to developing software. When the Internet began to expand after 1994, Portal grew too, and its sales doubled each year, eventually hitting \$103 million in 1999. Yet the company still had only 754 employees.

Portal gave employees options when they were hired, and then most people got them annually for promotions and special achievements. Portal went public in May of 1999 at the height of the boom. The stock soared 167 percent to \$12 that day, and by the time the employee cash-out date arrived in six months, the stock had hit \$80. Over the next year, Portal's stock fluctuated between \$27 and \$84. The outcome for everyone who exercised their options was an estimated \$1.3 billion, for an average of \$1.4 million each. In actuality, some employees had more options than others, so they did not all get that much, but Portal says that its IPO created 350 millionaires.

Owners focuses on the High Tech 100, the 100 largest public companies that derived more than half of their sales from the Internet as of October 2002. All but one trade on the NASDAQ, and their combined sales grew 78 percent between 1999 and 2001 to \$59 billion.

So Much Potential Ownership

The High Tech 100 can be used to track the extent of employee equity, including directly owned stock and unexercised options. On average, employee equity in these companies was 19 percent at the end of 2000 and the top five officers owned an additional 14 percent. The large management stake was usually because they were the original founders.

Never before has an entire industry had so much potential ownership by such a broad cross section of employees. The index also corrects the misconception that high-tech employees were left with nothing when the high-tech stocks collapsed. Although 83 percent of employee options were underwater by July 2002, and a potential \$171 billion was lost, the remaining 17 percent of employee options were worth \$4.4 billion, an average of \$25,000 per worker.

Who Owns How Much of the High-Tech Industry

Because options are only potential ownership, current stockholders could find their percentage of ownership diluted. Post dilution is the best way to look at who owns how much of the industry. Though high-tech CEOs and top managers do take almost as much for themselves as those in corporate America, they are much more generous to their employees. There is no evidence that since the crash these companies have stopped sharing ownership. They have accepted substantial dilution of their ownership stake because they believe in the incentive effect of stock option capitalism. Ninety-eight of the High Tech 100 companies provided options to most or all employees.

Underwater Stock Options

Despite 19 percent employee ownership, 83 percent of High Tech 100 options were underwater as of July 2002. There was misery among employees who had counted paper millions and lost it, those who came to a company at the end of the bull market, and those who were hit with unexpected taxes when the prices fell dramatically on their exercised but unsold options. However, losing real money as opposed to potential money on options was the exception. Though many people believed that options were a worthless form of compensation after the crash, High Tech 100 employees showed a net profit. ■

For Additional Information on who owns the high-tech industry, go to: <http://my.summary.com>

New Options Every Year

Looking at options from a bottom-line perspective understates the past and future benefits of partnership capitalism. The run rate, or the amount of equity a company hands out in employee options every year, is where the true value lies. Because the top five executives of High Tech 100 companies had so much equity, they generously dispersed about 8 percent of equity per year between 1997 and 2001 to increase overall employee ownership. About 7 percent of the equity went to employees, and their equity eventually eclipsed that of the top officers.

Management continues its commitment to sharing the risk and reward even after the crash by granting stock options every year with the price pegged to the current stock price. Annual option grants automatically readjust employee risk sharing. The run rate also made up for any wage substitution that was in place when the employee was originally hired.

Ensuring the Survival of an Ownership Culture

By constantly refreshing the employees' stake in the firm, the company can ensure the ownership culture will survive. And, indeed, High Tech 100 employees did not desert in droves for traditional companies after the meltdown. In fact, lower stock prices now make options more attractive to potential hires.

Despite annual grants of options, companies still felt the need to address the low morale of employees who saw paper fortunes disappear and who felt cheated out of the promise implied in wage substitution — lower pay for larger payout later. Microsoft handed out pay raises. Other companies raised the run rate. A quarter of the High Tech 100 companies pursued the controversial approach of exchanging old options for new ones, essentially repricing the strike price down. Outsiders felt it was cheating because part of the point of stock options is accepting the risk. Because companies replaced high-priced options with fewer low-priced options, it appeared that companies were reducing their run rate. But, in effect, they made options more likely to be successful and, thus, more likely to dilute.

Retention Difficulties and Poor Work Habits

When Amazon's stock fell from \$107 to \$30, and only 3 to 4 percent of employees had options that were worth anything, disappointment, resentment and diminished confidence in the company's future was reflected in poor work habits and retention difficulties. By August 2000, the stock was at \$16, but nearly 70 percent of the 70 million options held by employees had strike prices ranging up to \$83. Amazon allowed workers to trade older options for fewer options with strike prices at least 15 percent lower. By July 2002, only 13 percent of

Yahoo Shares the Wealth

Jerry Yang and David Filo started Yahoo in 1994, and they owned 100 percent of the stock. They sold shares to Sequoia Capital, a venture capital firm, and Softbank, another Internet firm. They also granted options to most employees and sold shares to the public in 1996. At that point, Yang and Filo each owned only 11 percent of the company after accounting for potential dilution. Other officers and directors held 7 percent, Sequoia held 13 percent, Softbank held 27 percent, employees' options were 17 percent, and public shareholders held 14 percent.

Yahoo continued to grant options to employees at a run rate of about 9 percent annually. They handed out almost 250 million options between 1994 and 2000, giving 12 percent to top executives and 88 percent to employees. By 2000, Yang and Filo's ownership had shrunk to 6 percent each and employees had a total potential ownership of 20 percent almost entirely through options.

workers' options were underwater. Many companies did not want to reprice because guidelines from the Financial Accounting Standards Board (FASB) required subtracting employee gain from earnings. But companies soon discovered a loophole that doesn't require the earnings hit if issuing the new options happens six months and one day after canceling the old ones. ■

Shareholders Gain By Giving up Ownership

The other side of stock options and the run rate is greater dilution of shareholders' equity stake. During the high-flying economy of the late 1990s, it seemed as though options were a zero-sum gain, because employees cashed out \$78 billion from the industry, while investors lost \$1 trillion. However, options can benefit both sides in a normal economy.

Stockholders definitely lose a small piece of their pie if options are exercised, but only if the stock price is growing. If the stock price is down, there is no dilution. Options can create extra value that offsets dilution by attracting and retaining an innovative work force and encouraging employees to think and act like owners.

In addition to dilution of shareholders' equity, companies bear the burden of the option overhang — the difference between the strike price and market price when the option is exercised. Another way to look at dilution is to examine total equity — the amount of stock owner-

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Shareholders Gain by Giving up Ownership (continued from page 5)

ship employees and investors would have if all options were exercised. The High Tech 100 only experienced a 16 percent dilution in 2000, far less than if the companies experienced the effect of the cumulative 8 percent run rate average of the preceding five years. This is because employees typically sell the stock they get into the public market. As a result, annual option grants continually dilute outside shareholders, but the total dilution and employees' collective ownership of the company is kept largely in check.

Options Seem Like Wages

To ameliorate dilution, companies get tax breaks on the spread between the exercise price and the market price at which they sold it. This makes the options seem like wages, and there is much discussion about whether options should be counted as real expenses against profits if they can be deducted for taxes. FASB guidelines require companies to report option expenses in a footnote.

Another benefit of options which offsets dilution is increased productivity. No one is sure how productivity gains happen, but since high-tech companies are based on knowledge and higher human productivity, partnership capitalism relies on the assumption that changes in employee behavior due to ownership are the key to productivity gains.

Investing Human Capital

Granting options causes employees to work hard for themselves, which is good for management and shareholders. Though they spend no money, they are invest-

ing their human capital. There is no guarantee that shareholders will benefit from increased productivity, but that is no different than any other investment, and options offer greater downside protection because failure costs nothing due to lack of dilution.

If used properly, partnership capitalism spreads both risks and rewards evenly between shareholders and employees, especially if the options are not repriced. There is no way to prove that the High Tech 100 could have done better if their shares were not diluted, but most CEOs are convinced options' increased value helped. And many of the startups would never have survived without the financial incentives of options. ■

For Additional Information about the mechanics of dilution,
go to: <http://my.summary.com>

Stockholders Come Out Ahead

The high-tech firms did not discover anything new, but they fused elements of sharing ownership with non-hierarchical workplaces to encourage employees to think like owners, and then they spread the idea across an entire industry. People have been sharing ownership for over 200 years. Twenty-four million workers or 23 percent of the work force are offered shares in their company through nonstock option plans such as 401(K)s or profit sharing plans.

Based on information synthesized from over 70 studies from the last 25 years, it is clear that investors profited if their company adopted key elements of partnership capitalism. Shareholders received a one-time bump where productivity improved by 4 percent on average; total shareholder returns increased by 2 percent relative to other firms; and profit levels measured by profit margins, ROA and ROE increased by 14 percent. These gains came after dilution and were created by granting roughly 8 percent of their shares to employees.

A Long History of Sharing Ownership and Risk

In the United States, there is a long history of sharing ownership and risk with workers. Early efforts such as whaling ships and sharecropping did not work because the workers lacked the authority to defend their interests. In the 1880s, companies such as Rand McNally and Proctor & Gamble set up profit-sharing plans. In the early 1900s, Filene's Department Store and Sears gave workers stock, and in 1927, DuPont began giving stock as a retention bonus.

Unfortunately, employee ownership never spread beyond a thin layer of leading companies in the early 1900s, and the Depression showed how risky owning company stock was when employees used their savings.

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How Risk Sharing Pays Off for Companies And Their Shareholders

Performance Measure	Gain from Partnership Capitalism
Total shareholder returns	2 percentage points
Productivity	4 percentage points
Return on equity	14%
Return on assets	12%
Profit margins	11%
Average employee ownership	8%*

NOTES: * After dilution

Total shareholder returns include stock price appreciation and reinvested dividends.

Productivity is defined as output per employee in some studies and as value-added per employee in others.

Return on equity is defined as after-tax profits divided by the outstanding shares.

Return on assets is defined as pretax profits divided by a firm's assets.

Profit margins are income before extraordinary items, taxes and depreciation, divided by total sales.

SOURCE: Authors' analysis of more than seventy empirical studies.

Stockholders Come Out Ahead

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During World War II, companies with a certain amount of profits got a tax break from sharing earnings with workers, and profit sharing became more popular through the decades, especially for pension plans. The advent of the 401(k) pushed almost all employee ownership into retirement saving. Employee stock ownership plans (ESOPs) also allowed employee stock purchases, and companies used them to ward off labor unrest and takeover bids. But they waned as management lost commitment to a culture of ownership, and accounting rules made them less desirable.

The Other Half of Participation Capitalism

Teamwork, the other half of participation capitalism, also took off in the 1940s and grew through the second half of the 20th century. Although teams seem prominent in the corporate landscape, only 12 percent of companies actually have a majority of employees working on teams. U.S. companies have been using elements of employee ownership and participation, but it is the High Tech 100 that has melded them together. An analysis of the 70 studies mentioned above shows the effects of employee ownership on the different elements of partnership capitalism.

- **Stock Options** — Broad based option companies performed better on corporate measures, and stock market returns were high. Stock options pay off the most when they go to mid- and lower-level employees.

- **Employee Stock Ownership** — Employee ownership seemed to correlate with higher stock prices in the studies. Companies with ESOPs were more stable, and their sales per worker grew faster than other companies.

- **Profit Sharing** — Splitting profits with employees improved productivity.

- **Employee Participation** — True employee motivation required both the financial incentive and the culture of participation. Companies increased their market value substantially and cut turnover by overhauling both culture and approach to pay. ■

For Additional Information on the early history of partnership capitalism in the United States, go to: <http://my.summary.com>

How Corporate America Must Change

If combining a culture of participation with the financial incentives of ownership is so effective for improving corporate performance, why is the high-tech industry the only one to have embraced it completely? Traditional corporations understand these benefits and try to accomplish them, but few involve more than half their employees in decision-making, and most employee

ownership is bought with workers' earnings not options.

Though traditional management does not motivate employees with ownership stakes as it claims, it does use that very argument to justify its own highly inflated salaries and compensation. As of 2000, the 1,500 largest public companies in the United States issued about 12 billion options valued at \$1.2 trillion. Roughly 30 percent of that wealth was in the hands of the top five executives. Most of the remaining 70 percent is spread across a thin layer of management that represents 5 percent of traditional companies. Corporate leaders want the higher productivity gains that employee ownership brings, but without paying for it. They claim employees are their most important asset, but the CEOs believe they deserve the majority of employee options because they are responsible for leaps in shareholder value.

Traditional Companies Offer Fewer Options

While High Tech 100 top executives keep the same 14 percent ownership as their Corporate America 100 counterparts, their employees receive 19 percent ownership while their counterparts receive 2 percent. Ninety-six of the Corporate America 100 have an employee stock option plan, but only six regularly give options to a majority of their workers. Except for the ESOP stock and employer matches in 401(k)s, employees at traditional corporations bought most of that equity with their own money, which only increases their risk.

In 1980, a sampling of the two highest-paid executives at nearly 500 firms showed they made an average of \$1.35 million each in today's dollars, mostly from salary and annual bonuses. Options accounted for only about a fifth of their earnings. By 2001, their average pay was \$11 million with 80 percent from options. The reason is that CEOs set their own salary. Although the board technically determines the amount, CEOs often hand pick the directors and dominate the board. Our business culture believes the genius corporate leader is the most important contribution to success, even though there is no clear evidence that CEOs create enough extra value to offset the dilution of their salary. ■

Putting It All Together

Traditional companies looking to apply this partnership capitalism model to a more traditional corporate setting will find that creating a more flexible, entrepreneurial and less hierarchical culture is the harder task, but deciding how to share ownership is also tricky. The High Tech 100 cannot be used as a guide because most traditional companies are not startups that can expect growth rates like Internet companies. Additionally, High Tech 100 companies are mostly knowledge based, not

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Putting It All Together

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equipment based. Companies that use more human capital than equipment can reap higher rewards from employee ownership.

Looking at traditional companies' own history shows that through ESOPs or profit sharing, corporations gave employees 8 percent of their shares. As a rough guide, traditional companies could expect a jump in profits and stock price if they shared a total of about 8 percent of ownership. The high run rates in the high-tech companies would over-dilute traditional companies. Different studies of traditional companies that do offer options to most employees average run rates of 3 to 4 percent. Run rates for companies that give exclusively to executives are about 2 percent.

This sounds small, but since 1926 the U.S. market has risen by 10 percent per year. An extra 20 percent return compounded over the years is significant. Companies can use these numbers as general guidelines, but they should adapt the concept to their own financial structure. Companies with higher stock market values for each employee will have an easier time issuing options. Companies with lower market values per worker could find it easier to pursue partnership capitalism by mixing option grants with ESOPs or profit-sharing programs. The best approach is to begin with a vision of the employee ownership you want to achieve and determine which mix of methods will work best for your situation.

Options should not be considered a form of compensation like salary or benefits. They represent risk shar-

ing and are an opportunity to become shareholders by spending human capital instead of cash. The regular wages and benefits that employees get for doing their jobs are a separate issue. Employee ownership delivers extra gains because employees do more than their regular jobs. Working harder and more efficiently is a real cost to employees, but it is often an easier way to pay for ownership than direct wage sacrifice.

To motivate employees, options should be a minimum of 15 percent of their annual paycheck every year. Though neither employees nor investors would be guaranteed extra return, they would probably get more over time because option profits grow with the market value of the company. Options also alleviate the problem of diversification for employees because they can take their wealth as soon as they vest and invest elsewhere. ■

Barriers to Partnership Capitalism

It is clear that corporate America would enjoy more motivated workers and larger profits if it embraced partnership capitalism. However, there will be challenges implementing the successful high-tech model into traditional companies. Even some high-tech companies may leave the model behind as growth slows and workers are easier to hire, though there is no evidence of this so far. Traditional companies should consider the following as they attempt to implement partnership capitalism:

- **Employees at traditional corporations lack the camaraderie born of shared technical interest to help promote the teamwork culture.**
- **Most companies will not expand at the phenomenal rate of the 1990s, so employees and investors will not see as large a gain.**
- **The large size of traditional companies breeds partnership-thwarting bureaucracy, and they have much slower decision-making processes which will impede the collaborative culture.**
- **Large companies will be dragged down by free riders if there is not enough employee cooperation.**
- **Companies can grant too many options so that the extra productivity will not overcome dilution.**
- **Boards must be strong and independent enough to ensure the options program is combined properly with the shift to a less hierarchical culture.**
- **Corporations need to have a viable plan for dealing with a long bear market.** Setting up profit-sharing programs is far better than shifting too much risk to shareholders by repricing.
- **The cult of the CEO will have to be tempered so all power is not pushed to the top where most of the option wealth is currently held.** ■

The Differences in Option Amounts at BEA Systems

Sharing the wealth doesn't mean social egalitarianism. There will still be differences according to what employees contribute. If those with greater skills bring greater value, they will get greater rewards. Bill Coleman of BEA Systems explains how more senior people receive more stock options because they can influence more of the success of the company. Coleman explains that he gives a new round of options every year, a "merit refresh," to employees whose individual performance puts them in the top 75 percent of the work force. He adds, "The top 25 percent get probably twice as much as the third quartile. And the bottom quartile, they don't get any refresh [just their initial option grant]. You really want to retain those top people. You want their handcuffs [from the option wealth they stand to collect when they vest] to get bigger and tighter."

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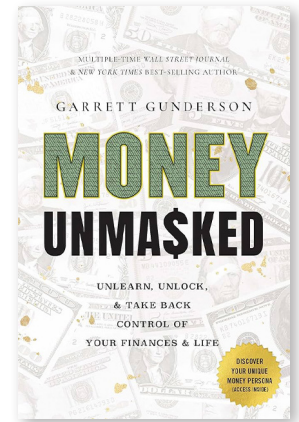
Money Unmasked

Garrett Gunderson

Money Unmasked

Unlearn, Unlock, and Take Back Control of Your Finances and Life

by **Garrett Gunderson**



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THE SUMMARY IN BRIEF

The century-old concepts of managing money rarely hold weight in today's world. Most of us scrimp and save, hustle and grind, only to find out it was never enough.

By busting the flawed philosophy of money, savings, and retirement, the book *Money Unmasked: Unlearn, Unlock, and Take Back Control of Your Finances and Life* unlocks a radically unique and efficient methodology to carving an exciting future. The book becomes your very own mantra for acquiring, retaining, and multiplying your money while making the most of life.

Author Garrett Gunderson helps you discover your Money Persona by offering insightful and actionable steps to reduce risk, tap into hidden capital, take calculated risks, and generate cash flow without having to trade your time for money.

IN THIS SUMMARY, YOU WILL LEARN:

- How to unlock your money persona.
- How to swap scarcity mindset with the cycle of creation.
- How to uncover hidden mental, relationship, and financial capital.
- How to create a framework to unlock profits.

Introduction

I'm a coal miner's son, like my father before. My great-grandfather was born into a life of scarcity and sacrifice. Because of my inherited scarcity mindset, I pinched pennies and hoarded money like a prepper storing supplies for the apocalypse. I also inherited my family's work ethic, which, combined with a scarcity mindset, caused me to spend most of my time working to earn as much money as possible. Saving and making money were my primary goals.

You see, a scarcity mindset is an epidemic. The world we live in is fueled by it. The belief that resources are scarce is by far the greatest destroyer of wealth. In scarcity, we ignore resourcefulness, collaboration, and innovation. The belief that resources are limited means everything is a win-lose transaction rooted in competition, fear, destruction, and even entitlement. The outcome of scarcity is sacrifice – where we hear, accept, and then live by the myths and misinformation that hold us back.

At some point, I started dropping the myths by which I had lived my life. I abandoned the scarcity mindset and all the lies I had believed about money – for good. And then, I asked myself a series of questions, which unlocked the hidden magic number. Those questions became the Value Index.

Chapter 1: What's Your Number?

Now, right, now, imagine you're given ten dollars every month, for the rest of your life. What would you do with that extra money? How do you feel about having that money? Now, imagine you're given one hundred dollars every month. What would you do? Let's add another zero. What would you do? Keep going. Add more zeros. You know what's coming. At every stage, jot down how you'd feel about it and what you'd do with it. Finally, what would you do if you were given a billion dollars? What if you were a billionaire?

At what point in this exercise did you stop thinking about what you could buy, or what the money could do for you, and start thinking about the value you could create for others? What was your number? If you made the flip at ten thousand a month, that is your hidden number. I call it the Value Index. This is the point when we turn our attention to value for others rather than consumption for ourselves.

Only when you find your Value Index, when money is no longer your primary reason or excuse for doing or not doing something, the space for possibility opens up. When we put value first, we can expand our vision. Remember

though, it's not about the number. It's about the perspective, the vision. Vision is the ultimate container to create value. It creates context and determines actions.

Now that you have your Value Index number, remove the constraints of time, money, and even ability. Those are only limiting factors when you try to do too much alone or too quickly. Just be willing to dream without restrictions. What calls you? What compels you? Your Value Index is also about being in the mindset where it gets to be about you, your life, your vision today. Start thinking about how you can make that vision happen. Not when you get enough money to pull it off. But now – start now.

Chapter 2: Win, Then Play

What is success, and what does success mean to you? Society will have us believe it is solely about recognition, money, and comparison: Do you have more than others? Again, society also tells us to sacrifice for “someday.”

Win, Then Play isn't about someday. It's about now. It's about building a legacy that will last well beyond your lifetime. It's about creating a purpose compelling enough to captivate you over a lifetime. Win, Then Play comes from focusing on your quality of life first and foremost; then your value is a by-product of a life well lived. And money follows value. In Win, Then Play, we begin with value, expansion, and innovation, grounded in the belief that there are more than enough resources through human ingenuity. People who operate from abundance know that by creating value, and thus creating happiness in the lives of others, they bring more happiness to themselves.

Define your game up front and make sure it is one worth winning. If you can't create a win before playing, you don't play. Here, vision is the win. Value is the way. Dollars are the by-product. And prosperity is your state of being.

Avoid escapism in the form of binge-watching sitcoms, sports talk programs, and more. Lean on hobbies to help you eliminate the outside noise and find your inner voice and vision. By doing the Value Index exercise, I went from being stumped with the billion-dollar question to creating a vision of helping one billion people in the way I enjoy most: entertainment through performance and comedy. Finally, avoid the validation trap. Instead, be willing to listen to your intuition and embrace the power of possibilities. People fear what they don't understand, reject what they can't comprehend, and protect what they are already committed to: the

It's not just about how much money you have,
but how well that money serves you in terms of living
a life you love, and how it serves others.

losing games. But to heal from a losing game, we first have to know we're playing it.

Chapter 3: The Losing Games

In my theatrical keynote, *Already Won*, I perform a scene from an imaginary road trip with four passengers. These passengers argue with each other, are focused only on their goals and not the ultimate goal, and simply can't seem to work together. They represent the Four Shadow Personas that drives most of us. They keep you from having great experiences and even arriving at your destination.

There are Four Shadow Personas that evolve from the Consumer Condition. They are then reinforced by our inherited money mindsets and unresolved childhood traumas. These personas are: The Striver, The Miser, The Conservative, and The High Roller. We typically let one of the personas drive us at any given time, though sometimes one of them is a backseat driver. After having your Value Index number, the next step is to become the Shadow Persona that may be driving your financial, business, and life decisions.

Far too many people get sucked into Shadow Personas because they don't look down the road to see what will happen if they "win" their chosen game. The Miser ends up with cash he won't spend. The Conservative ends up with retirement funds he can't spend for fear of running out. The Striver burns out. The High Roller winds up with short-lived riches. The Shadow Personas are selfish, trapping us in a losing game. We may not be one of these Shadow Personas all the time, but we aren't so enlightened that none of these personas show up in our lives from time to time.

A Winning Persona is unlocked when your focus becomes about value, service, and solving problems for others. The Striver is an impatient, busy malcontent. But, on the flip side is their Winning Persona, the Creator, an innovator, or entrepreneur. The Creator focuses on self-discovery to find contentment in the value they create. The Miser's Winning Persona is the Mindful Manager – detail-oriented, efficient, and great at improving things. The Conservative is the

Planner, a stable, secure, thoughtful, and strategic person, who can be instrumental in minimizing risk and planning for contingencies. The High Roller's Winning Persona is the Catalyst: a visionary and a connector. They think and play big, uplifting others by finding ways to grow together.

You may already have a sense of which Shadow Personas you've allowed to drive your life and work. Flipping from the Shadow Persona to the Winning Persona is about expanding your value. It's not just about how much money you have, but how well that money serves you in terms of living a life you love, and how it serves others.

Chapter 4: The Flip

Flip from your Shadow to Winning Money Persona with this four-part formula to access results, minimize risk, and create a life you don't want to retire from.

Step One: Co-Create

When people think they must do everything by themselves, they get trapped in a Shadow Persona. Find one person with whom you can share your ideas or issues, someone who can support or inspire you. Find a co-creator who can create accountability or possibility to move beyond the Consumer Condition into creation. The outcome? Accelerated and enjoyable results.

Step Two: Eliminate

Before you start something new, create space for your life and let something go – physically and mentally. Remember, anything that isn't addressed – due to fear of rejection, judgment, or confrontation – simply takes more time and in the long run destroys our ability to create. To eliminate escapism, simply ask yourself, "What's not working, and how do I want it to work?" Do this regarding your health, relationships, finances, or any area.

Step 3: Delegate

Delegation may seem hard now, but it becomes easy later. Tasks are like boomerangs. They just keep coming back

around. So, delegate roles. By addressing escapism, you can recover and find more time. With the additional time, you can train and hire people to delegate to. This increased time and production allows for you to do what you do best, but to do this, hire people in their Winning Persona.

Step 4: Collaborate

The fourth step to a winning game is collaboration. It's about bringing in capabilities that the team didn't previously have. Whereas delegation can bring you support to perform better and be more efficient, collaboration helps you bring in capabilities that expand your vision. Find those people who are the Winning Personas that you are not. Find the ones missing from your team to accomplish more by utilizing their skills and leveraging yours.

Chapter 5: Unlock Hidden Capital

Knowing where your Hidden Capital is, how to develop it, expand it, and utilize it is the key to wealth. The key to creating your winning game. The key to finally understanding and abolishing scarcity.

First: Mental Capital

You are the greatest asset – not a bond, stock, or even a piece of real estate. Your Mental Capital is the key to unlocking your assets, and your value. Mental Capital includes: Education, Experiences, Insights, Interests, Tools, and Skills.

It is the combination of your ideas and skills, your experience, emotional intelligence, and integrity. It's everything that you know. Mental Capital accelerates with integrity. By being true to who you are, you unlock more of what you know. Create your own path. Discover what drives you and accelerate results by knowing what you love and what you do best. Become curious. What problems are you uniquely gifted to solve? In what ways are you compelled to naturally serve? Ask questions, stay in inquiry to find out what makes other people tick, and discover what they care about. The process can be difficult. But know that you'll get there eventually.

Next: Relationship Capital

Relationship Capital is the most underutilized asset in the world. It comes from people (both online and in person) who know how to create value and know how to receive and ask for value as well. It comes from those with whom you have built relationships and even the relationships from those you know, their network. Relationship Capital includes: Subscribers, Customers, Mentors, Family, Friends, and Team.

Invest in people. Get to know them. Be present. In communication, you don't have to have an agenda or try and earn anything. Just open up. Just share. Be real. Be vulnerable. Be perfectly imperfect. Take your time to build relationships. Delegate as a way to free up your time and connect with those who are serving you. Unlock Relationship Capital by making a list of your constraints, distractions, and obstacles. If you don't know who can help you, simply make a list of people in your personal and professional network.

The Value Equation is the key to Win, Then Play. It is the process of leveraging knowledge and engaging people to create profit. Value Equation is:

Mental Capital x Relationship Capital = Financial Capital.

Remember, whenever we think we have a money problem, it isn't a money problem; it's a Mental or Relationship Capital issue. People love the opportunity to serve and support things they value. Be a value creator. Be referable. Add value in all situations for your Relationship Capital list. Over time, you'll find that the value you receive reflects the value you give and who you are.

Chapter 6: The Cycle of Creation

The Cycle of Creation engages you Mental and Relationship Capital, to collaborate with others and focus on what you do best. You identify the best opportunities and then build them into immediate revenue streams or abandon them before spending substantial time or money. The process breaks down into four steps:

Step One: Brainstorm and Analyze Ideas

Start with a vision. What do you see that others don't? In what ways do you have the excitement and energy to invent or improve? If you aren't sure what to invent, ask, "What problems do people face?" Once you have an idea you want to run with, check in with yourself. Is this idea in alignment with your Value Index? Will it help you realize your vision and live a life you love?

Step Two: Turn Ideas into Concept

A concept bridges the gap between an idea and a plan. It refines your sense of how you're going to add value in a way you can easily explain. An idea becomes a concept when it is shared with others, focusing on being more detailed and specific. You know you have a solid concept when you can clearly and succinctly describe the essence of the business to others in two or three sentences.

You know you have a solid concept when you can clearly and succinctly describe the essence of the business to others in two or three sentences.

Step Three: Build a Framework

A framework provides a blueprint for implementing your refined concept. The Creator's vision initiates the process, and the framework makes the vision a reality without requiring you to be involved moment by moment or step by step. The right framework helps detail how other people will be involved and gives them the tools to build this for and with you.

Step Four: Take a Product, Service, or Experience to the Marketplace

With your framework created, now it's time to take your idea to market as an actual product, service, or experience. At this point, you're certain you can monetize your idea because you already have customers. If you don't already have a database of subscribers or fans, you can start by offering your product or service to Catalysts – those influential relationships who can become spokespeople for what you do. Implement the framework you've created and refine it over time to improve reach, productivity, and leverage. Use the funds from earlier stages to pay for those supporting the framework.

Chapter 7: Reclaim Time

Time is not money. Money can be misleading when it tempts us to chase it – at the expense of our time, our vision, and ultimately our life.

When we're trapped in the business of the world, it's difficult to hear the inner voice that guides us, much less take the time to listen and find that inner voice. Find your inner process, and discover what works best for you. You may be excited to act on all you've learned in this book so far, ready to step into your Winning Persona, leverage your Mental and Relationship Capital, and begin the Cycle of Creation, but first, listen. Make and invest time. Create space. Make your very own rules for using your time. Separate your thoughts and action items into four categories:

- Doing. What are the things to do in the next two weeks? Rather than create a task list, add it in time and space in your calendar.

- Later. Jot down actions to take eventually. Use a journal or an app and move them to your calendar later.
- Never. Give up the things that don't fit into your Value Index.
- Parking Lot. Here, you put "someday" ideas, the fruits of your brainstorm. Allot space for what might come up without any concern for how and when.

You can review your parking lot and later categories as frequently as you like. Say no to opportunities that drain you. Be conscious in relationships. Carefully choose the people you want to spend your time with. The rules and boundaries you don't create invite the world to decide for you. And the world and society have an insatiable appetite for consumption. Until you know your value and define your win, there will never be enough time.

So know your win, know your rules, and live life on your terms. Invest in yourself and your lifestyle. Then continually blur the lines between work and play.

Chapter 8: Reclaim Cash

You can save and accumulate net worth, but once you've built net worth, how do you access and utilize it?

Economic independence is when you have enough recurring revenue (aka cash flow) to cover your basic expenses from your assets. It is when income comes in even if you're not working that day. It doesn't mean that income is completely passive, because you still monitor, manage, and maintain it. When you create economic independence, you have more choice, and more freedom.

Cash flow can be created by tapping into your Mental and Relationship Capital through building businesses, or investing in tangible and intangible assets, such as real estate or intellectual property, anything that can produce ongoing income.

Understand that net worth is not your worth. Retirement planning often focuses on net worth and neglects cash flow. Unfortunately, with retirement planning, "investing" and "stocks" are basically synonymous. Many people don't re-

alize the variety of investment options they have. The more we set money aside in investments we don't understand, for a payoff in the far-off future, the more risks we take.

Boost your bottom line and plug leaks. When it comes to expenses, the standard advice we're often given is to scrimp, sacrifice, and save. However, no one shrinks their way to wealth, no matter what the Miser says. Some expenses you will want to eliminate, but others are best to manage, address, and even increase. Those stuck Playing Not to Lose overemphasize budgeting. Unfortunately, budgeting has come to mean can't: I can't afford it, I can't arrange that trip with family.

People lose 10 percent of their income through unnecessary taxes, interest, insurance, and investment fees. Instead of budgeting, it's important to structure each one of these properly. This frees up more way more cash. In my first book, *Killing Sacred Cows*, I illustrate how to detect and eliminate nonperforming fees. In *Budgeting Sucks* I unveil Cash Flow Optimization and all the ways you can reduce your interest rates by renegotiating, restructuring, and reallocating (3Rs).

Be conscious with your money. Mindful Cash Management is a methodology where you don't track your expenses down to the last penny. Instead, you prioritize to get the most out of your spending. It ensures you're aware of your expenses but not held captive by them. The process involves tracking your expenses and cash flow on a weekly or biweekly basis. Look at your expenses over the next thirty days and categorize them into one of these four expense categories:

- Destructive. Expenses that limit your human value, cause you to go into debt, or go unused.
- Lifestyle. Expenses that allow you to enjoy life.
- Protective. Expenses that manage your risk and protect you and your property from damage or loss.
- Productive. Expenses that enhance your life now and in the future.
- Once you categorize these expenses:
- ELIMINATE destructive expenses
- MANAGE lifestyle expenses by paying cash for these expenses
- ADDRESS protective expenses to maximize their efficiency
- INCREASE productive expenses

- Finally, build a solid foundation by answering questions like:
- Have you transferred catastrophic risks through proper insurance, corporate structure, estate planning, and asset protection?
- Have you built up at least six months of liquidity?
- Have you utilized risk mitigation techniques to protect your downside by adding collateral, obtaining personal guarantees, or putting stop-losses on your investments?

This is all a part of a practical application to support peace of mind, and clarity, and build financial confidence so you can build and live the life you love.

Chapter 9: The Love Movement

Love is a choice. In the face of all complexity and adversity, it is in our power to choose love. Now, love doesn't require you to agree or behave in a way that fits anyone's control fantasy. Conditional love is a mistake. Live a life you love, learn from your mistakes, take responsibility, and know that your mistakes don't make you less lovable. Know you are loved. Know you are valuable. Know you are enough.

Conclusion: An Extraordinary Life

You're not the same person you were when you started reading this book. What will you do with these strategies? Your newfound knowledge? What impact could you have simply by doing what you are called to do, doing what interests you, doing what gives you joy?

What's Your Number? is about living your life from abundance. Even if you're struggling to make ends meet, be more resourceful. Tap into your Relationship Capital. Ask for support. You are not alone. It is time. Time to create space for you. Find your flow. An extraordinary life awaits and depends on it!



Garrett Gunderson is the author of the New York Times and Wall Street Journal bestselling personal finance book *Killing Sacred Cows: Overcoming the Financial Myths That Are Destroying Your Prosperity*. He is the Founder and Chief Wealth Architect of the Inc. 500 firm, Wealth Factory. A regular on ABC's Good Money, he has been on Fox, CNBC, as well as hundreds of radio interviews, and is a contributor for Forbes. Garrett is a frequent speaker at workshops and conferences. He lives in Salt Lake City.

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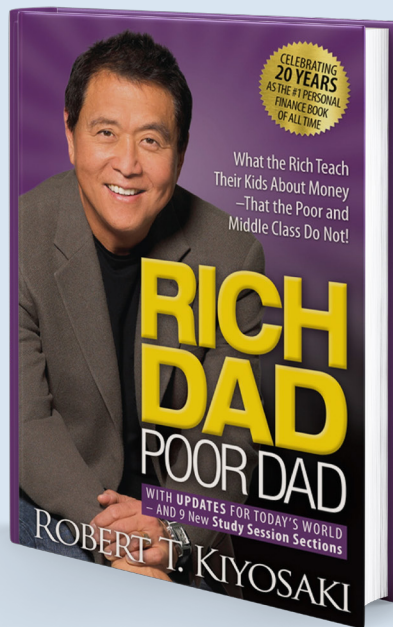
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Rich Dad Poor Dad

Robert T. Kiyosaki

Book Snaps™

In-depth reviews of best-selling business books.



Rich Dad Poor Dad

**What the Rich Teach Their Kids About Money
That the Poor and Middle Class Do Not!**

By Robert T. Kiyosaki

Robert Kiyosaki is an investor, entrepreneur and educator whose perspectives on money and investing fly in the face of conventional wisdom. He has, virtually single-handedly, challenged and changed the way tens of millions, around the world, think about money. In communicating his point of view on why 'old' advice - get a good job, save money, get out of debt, invest for the long term, and diversify - is 'bad' (both obsolete and flawed) advice, Robert has earned a reputation for straight talk, irreverence and courage. *Rich Dad Poor Dad* ranks as the longest-running bestseller on all four of the lists that report to Publisher's Weekly and it has sold over 27 million copies worldwide.

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A Book Review by Soundview

Working for Money vs. Having Your Money Work for You

Rich Dad Poor Dad was originally self-published because it was rejected time and again by publishing houses. When it was eventually picked up, it was far from an instant success. In fact, it was highly criticized for the same reasons it was widely rejected by publishers as a manuscript. Publishers, readers, and critics dismissed the author, saying Kiyosaki "didn't know what he was talking about." They disagreed with the foundational lessons being presented, which have proven to be "prophetic" in hindsight. More than 20 years have passed since the first official release. It is now recognized as "the number one personal finance book in history," spending nearly seven years on The New York Times bestseller list with an "estimated 40 million copies" sold worldwide.

One of the main attractions of the book is its unique perspective. Kiyosaki explains that he was given the opportunity to choose between following the financial advice of two different dads: one rich and one poor, one the father of his best friend Mike, the other his own. Both were well educated and earned a significant income. However, one ended up with millions to give away and the other ended up with stacks of bills to pay. The rich and poor dads had opposing views and attitudes about money. Kiyosaki made a choice to listen to the rich dad's advice over his own poor dad's and it "shaped the rest of [his] life."

In *Rich Dad Poor Dad*, Kiyosaki presents six main lessons he learned from Rich Dad as "simply as possible" just as they were presented to him all those many years ago. They are intended to be "guideposts," not firm directives and are more applicable today than ever. If followed, they will help people, their children, and their families "grow wealthier no matter what happens in a world of increasing change and uncertainty."

Lesson #1: The Rich Don't Work for Money

Kiyosaki and his friend Mike asked Mike's dad, who was the rich dad, to teach them about money. He agreed and invited them to work for him at one of his nine small grocery stores

in the area for a meager \$0.10 per hour. After several weeks of dusting canned goods and restocking shelves, Kiyosaki became frustrated. He had not been taught anything by Rich Dad and was working hard for very low wages. He told his friend that he intended to quit. To his surprise, Mike seemed to be waiting for him to threaten that. Kiyosaki was granted an in-person meeting with Rich Dad to discuss his frustrations.

Over the course of that conversation, Rich Dad helped Kiyosaki understand that most people spend their lives working for others. If they are unhappy with how much they make, they simply leave that job and search for another one. They believe that making more money slowly over time through raises and promotions is the answer to all financial problems, but they are wrong. This only leads to being controlled by fear and greed. They are motivated to work for fear of not being secure. The more money they earn, the more they spend because they feel they can now afford such luxuries. This gives birth to a trap commonly called “the rat race.” The only way out is to fundamentally change the way they think about money.

The Rich Dad shared this “pivotal point of view” that Kiyosaki calls lesson number one. The fundamental difference between poor and middle class people and those that are rich is this: “The poor and the middle class work for money. The rich have money work for them.” Purchasing or creating assets that “deliver cash flow” is the primary means to “generate income that doesn’t come from a paycheck.” When your money creates money, you are free from the pattern and you can become financially free.

Lesson #2: Teaching Financial Literacy

Time and again we hear stories about people who have earned or won or inherited massive sums of money only to die penniless or worse, leave this earth with large debts their family has to take over. Financial literacy is the missing ingredient in many of these sad stories. Rich Dad told Kiyosaki, “If you want to be rich, you need to be financially literate.” What he meant is that simply becoming rich is not the answer. Making sure you and the generations to come after you keep the wealth that was built, requires a financial education. Our school system fails heartily in this regard so those who wish to build a lasting foundation of financial well being must seek this education themselves.

We are taught that the American Dream is to buy a house and live in suburbia. However, Kiyosaki points out, the mass majority of people don’t have an asset in a home, they have a liability. In order to become wealthy, people need to buy assets, not liabilities. This very simple rule comes down to knowing the difference between the two. “An asset puts money in someone’s pocket. A liability takes money out of someone’s pocket.” Assets and liabilities are defined by numbers, not words. A large majority of Americans work very hard to get ahead and earn good money doing it. However, they fail to create wealth “because they spend their lives buying liabilities instead of assets.”

Prime examples of liabilities include “mortgages, car loans, credit card debt, and other loans.” Prime examples of assets include “real estate, stocks, bonds, notes, and intellectual

property.” Those assets produce income in the form of “Rental income, dividends, interest, and royalties.”

Lesson #3: Mind Your Own Business

There is a difference between your profession and your business. Modern education teaches people to become professionals. Students focus on engineering or cooking or science and go on to become “engineers, chefs, or scientists.” They earn income working professionally in these areas. When asked “what is your business” someone will say that they are a banker, for example, although that person does not own the bank. This person has “confused their profession with their business.” They are making money for the bank, making it rich. “To become financially secure, a person needs to mind their own business” instead of “minding someone else’s.” It is only your business if it “revolves around your asset column, not your income column.” Income needs to be “used to purchase income-generating assets.”

Lesson #4: Taxes and the Power of Corporations

In studying the history of taxes with his rich dad, Kiyosaki learned that the government “drives tax revenue from the middle class.” The government continually grows bigger and more and more revenue is needed to sustain it. The rich “don’t play by the same set of rules.” They recognized an opportunity in establishing corporations that is used widely today to shield the rich from the large tax burden they would otherwise face. “This knowledge of the legal corporate structure is what really gives the rich a vast advantage over the poor and the middle class.”

Capitalists have applied their financial knowledge “to find an escape” in the filing of corporations. Many people don’t realize that a corporation is not a thing. “It’s not a big building or a factory or a group of people.” It is “merely a legal document that creates a legal body without a soul.” And that legal body protects the wealth of rich people because corporations have far more tax shelters than individuals. People are taxed at higher rates than corporations and corporations can pay some of their expenses “with pre-tax dollars.” At the end of it all, it means that rich people who create corporations end up keeping more of their money than middle class and poor people.

Lesson #5: The Rich Create Money

Kiyosaki had been teaching professionally since the mid 1980’s and in the “thousands of individuals” he had instructed over the years, he noticed a common and disturbing commonality. Regardless of the “tremendous potential” each and every person possesses, we are all held back to one degree or another by a “lack of self-confidence.” Once we leave our formal education, there is a certain amount of “guts, audacity, bravado, tenacity, or brilliance” that shapes our future far more than whatever grades were listed on our report cards. Many of us have a nearly impossible time tapping into that x-factor. Instead, we get weighed down by “excessive fear and self doubt.” “Financial genius requires both technical knowledge as well as



Those who can come up with ideas and put them into practice are “creating their own luck” instead of wasting their financial intelligence waiting for luck to find them.

courage.” This ability to take risks can make the difference between being rich and being poor or middle class.

In times past, the people who owned the most land were the wealthiest. Later, those who produced and sold the most goods became the richest. The modern world financially favors those with information. Those who can come up with ideas and put them into practice are “creating their own luck” instead of wasting their financial intelligence waiting for luck to find them. The Information Age is filled with opportunities to create money from nothing other than “ideas and agreements.” When people put their energy and focus into developing their financial intelligence they are ready and willing to take advantage of opportunities that come about in an ever-changing world. Markets will boom and markets will crash. It is inevitable. Those with finely tuned financial intelligence will be ready to take “the lemons and turn them into millions.”

Lesson #6: Work to Learn

Our society’s educational and professional systems are set up to promote specialization. We are pushed to become doctors, lawyers, architects, or engineers. The school system “rewards people who study more and more about less and less.” Rich dad’s philosophy was just the opposite. His suggestion was to “know a little about a lot.” Kiyosaki applied this principle by undertaking various roles in every department at rich dad’s portfolio of companies. Later, after graduating from the U.S. Merchant Marine Academy he worked on an oil-tanker fleet, joined the Marine Corp to learn how to fly, and then joined Xerox to learn how to sell. His poor dad didn’t understand all of this bouncing around. His rich dad praised him.

Kiyosaki was seeking out a diversity of learning so that he could maximize his earnings. This is what he recommends to young people today. He says people should take a look into the future, decide what they want, and then learn the various skills required to get what they want. If the idea of “working to learn something new” is not desirable, specialization should be approached with caution. Kiyosaki recommends ensuring protection through unions in the case of highly specialized careers like public education or commercial piloting.

Five Obstacles

Life is full of bumps on the road and without a doubt, there will be obstacles along the way to financial independence. Kiyosaki describes five main reasons “why financially literate people may still not develop abundant asset columns that could produce large cash flow.”

1. Failure to overcome fear. Everyone has a real and honest fear of losing money. The fear itself is not the problem. The way someone handles that fear contributes to how rich or poor a person may become. Being too afraid to lose means that you can never win.
2. Letting Chicken Little cynicism rule the roost. We have all heard the story of the little chicken that convinced the entire barnyard that the sky was falling when in reality, he was merely hit in the head by a tiny acorn. The world is full of “doom and gloom” rumors that make people pull back and assume the worst. Rising above this and believing in the possibilities can create hard cash opportunities.
3. Laziness through busy-ness. Our society is chock full of people who are “too busy” to work on things that matter the most. They let their health go, fail to take care of relationships, and end up losing it all. Staying busy is really a form of laziness only overcome with a little greed.
4. Habits controlling behavior. Most people put themselves last, paying bills and such first and only paying themselves with anything left over, which is often little or nothing at all. The rich make it a habit to “pay themselves first” so they are then motivated to take care of obligations like bills and taxes. The drive to avoid hearing from the bill collectors and tax man is so great that they find a way to make the money.
5. Using arrogance to hide ignorance. People lose money when they don’t understand what is important in a particular transaction. This act of pushing aside their ignorance is a form of arrogance. The antidote to ignorance is education. Become literate and bring that knowledge to the wealth-building table.

The mission of The Rich Dad Company and therefore, of Robert T. Kiyosaki, is “to elevate the financial well-being of humanity.” This book was the start to a personal finance revolution that has changed the way “tens of millions” of people look at and handle money. The ideas presented remain controversial, as they go against long held beliefs about education, savings, and career. But as the saying goes, hindsight is 20/20. The most fiercely challenged suppositions of Kiyosaki’s seminal work have played out with almost supernatural accuracy in the more than 20 years since it was originally released. Kiyosaki’s Rich Dad lessons have the power to change the financial future of each reader, “one life and one person at a time.” This promise is available to anyone willing to build their financial literacy and wealth the “rich dad” way.

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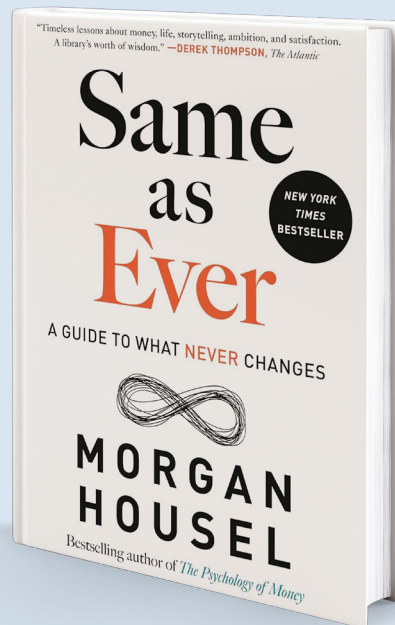
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Same As Ever

Morgan Housel

Book Snaps™

In-depth reviews of best-selling business books.



Same As Ever

A Guide to What Never Changes

By Morgan Housel

Morgan Housel is a partner at The Collaborative Fund. He is a two-time winner of the Best in Business Award from the Society of American Business Editors and Writers, winner of the New York Times Sidney Award, and a two-time finalist for the Gerald Loeb Award for Distinguished Business and Financial Journalism.

A Book Review by Soundview

Reaching New Levels of Mastery

Same As Ever author, Morgan Housel, understands that many things change in the world. He recognizes the surprises and the unanticipated situations that change history, but he focuses his attention on that which never changes. He explains that by looking back towards the past, he becomes more confident in the future because he can recognize the unchanging in our seemingly ever-changing world. He explores twenty-three of these unchanging facets of life and human nature in his book, *Same As Ever: A Guide to What Never Changes*, each in its own chapter.

Random Events

Housel loved to ski when he was younger. One day two of his friends, Brendan and Bryan, wanted to ski out of bounds which could prove dangerous. None of the three knew that conditions at the time were optimal for avalanches. While Housel had skied out of bounds before, for reasons he does not quite understand, he decided not to join his two friends this time around. Instead, he planned to meet them at the bottom with his car and drive them back. He got to the appointed place, but his friends never showed up. He assumed that this meant they had gotten back some other way, and he left. Eventually he got a phone call from Bryan's mom asking if she knew where her son was. Bryan never showed up for work. A search ensues, and eventually the two boys are found dead from an avalanche. Had Housel gone with them, he almost certainly would have died as well. When Housel went to see his father later that day, his father was quite upset as he greeted him. It is at this moment that Housel realized just how close he came to meeting the same fate as his friends. To this day, he cannot explain why he decided not to go with them.

Housel uses this anecdote as well as a few others to explain his first unchanging principle: "some of the biggest and most consequential changes in history happened because of a random, unforeseeable, thoughtless encounter or decision that led to magic or mayhem." He believes that predictions need to be based upon the past behavior of people because it is too difficult to predict what future events will occur. Because part of human nature is predictable and largely unchanging, the principles he puts forth in the rest of the book are of note.

Preparation

He moves from this idea to his next: “We are very good at predicting the future, except for the surprises - which tend to be all that matter.” He guarantees his reader that the biggest events to come are ones that people did not predict, and he encourages his reader to prepare for not just foreseeable risks but also for unforeseeable ones as well. He uses the story of Harry Houdini to explain why it is important to prepare for that which cannot be anticipated. Harry Houdini would frequently ask a person in his audience to punch him in the stomach. Houdini knew how to handle the punches because he was an amateur fighter. One day, however, a man came up to him, knowing Houdini’s penchant for asking for punches, and he punched Houdini in the stomach when he was not prepared. Houdini’s appendix bursts the next day from the punch. Houdini was an expert at getting out of difficult, anticipated circumstances, but he was felled by a punch he never saw coming. This demonstrates the degree to which the unanticipated can harm even the most prepared people.

Housel notes in this chapter that when people spend all of their time preparing for anticipated risks, they can fail to prepare for those risks they cannot anticipate. He mentions personal finance, and when taking this principle into effect, he believes a person should always save more than they believe they will need, and people should accrue less debt than they believe they can handle. He discusses the way that the state of California prepares for earthquakes. Officials in California know neither where nor when a major earthquake will happen, but they are certain one will occur. Therefore, they make sure that emergency crews are always prepared and that buildings are designed in a way to withstand an earthquake. They do all of this knowing that the earthquake they are preparing for may not occur for another hundred years. They cannot predict, but they can plan.

Expectations

In his next chapter, Housel states that “there is no such thing as objective wealth – everything is relative, and mostly relative to those around you.” He goes on to consider the 1950s. By most measures, people are better off today than people were back then. This does not stop people from yearning for that area. He believes that one reason many people felt content in the 1950s was that the gap between the poor and the wealthy was quite small. This small gap occurred because The National War Labor Board set most wages between 1942 and 1945, and even after this was lifted, the gap remained fairly small. Therefore, when people compared themselves to those around them, they saw that they were doing very similarly, and this bred contentment. Even though wages were not high, neither were neighbor’s wages. Smaller houses and hand me downs were the norm, so people were okay living this lifestyle. Housel compares this to the modern day where people spend considerable time on social media. Today people compare their own lifestyles to those they see online, and they yearn for what others have even though often what others have is embellished or downright fabricated. He writes, “Today’s economy is good at generating three things: wealth, the ability to show off wealth, and great envy for other people’s wealth.”

What is unchanging is people’s tendency to be driven by the goods of others. Expectations, therefore, are quite important because unmet expectations lead to unhappiness.

Stories and the Unmeasurable

Housel moves on to state that “stories are always more powerful than statistics.” He believes that people who are the most likely to get ahead are those who have the correct answer to a problem and who also have the ability to tell a good story. Without a good story, getting ahead is not certain. Storytelling is so important that he believes that even people who are wrong can get ahead for a while if they are able to tell a good story. He discusses the story behind Martin Luther King Jr’s “I Have a Dream” speech. The most famous part of the speech was not prewritten. King was giving his address when he heard Mahalia Jackson say, “Tell ‘em about the dream, Martin!” He heard this and abandoned the next part of his speech, instead opting to give the most famous part of his speech unplanned. Housel believes that this part of King’s speech was one of the best stories ever told in that it connected details that had previously been unconnected in people’s minds. He goes on to say that “good stories tend to do that. They have extraordinary ability to evoke positive emotions, bringing insight and attention to topics that people tend to ignore when they’ve previously been presented with nothing but facts.” He then goes on to discuss storytellers like Ken Burns, Bill Bryson, and Charles Darwin who made names for themselves not by presenting new information but by presenting old information in a story that engages the imaginations of the audience. He provides some guidelines for crafting compelling stories as he maintains that “the most persuasive stories are about what you want to believe is true, or are an extension of what you’ve experienced firsthand.”

He moves on to state that “The world is driven by forces that cannot be measured.” To explain this principle, he considers the career of Robert McNamara. McNamara worked for Henry Ford and helped the company excel. To turn the business around, McNamara focused extensively on “the ice-cold truth of statistics.” McNamara went on to become the Secretary of Defense while the United States was embroiled in the Vietnam War. McNamara took what he knew, the benefits of data, and used it in his management of the war. What was successful at Ford was not successful in Vietnam, however, and this is because McNamara’s statistics failed to account for the Vietnamese people’s feelings. When Americans were killing 10 Vietnamese people for each American death, Americans were only concerned with the one dead American. This led Ho Chi Minh to say “you will kill ten of us, and we will kill one of you, but it is you who will tire first.” Housel agrees that without measurable points, knowledge is lacking, but he goes on to say that even with clear data and statistics on measurable points, the whole picture may not be seen. He believes that “some of the most important forces in the world – particularly those regarding people’s personalities and mindsets – are nearly impossible to measure and impossible to predict.” He then quotes Jeff Bezos who claims to take the side of anecdotes when they conflict with data.



... people will often eschew simplicity, even when it is effective, and instead opt for complexity.”

Hard Work and Complexity

Later on in his book, Housel details the tragedy of the Donner party. The party had set out in the 1800s to travel from Illinois to California. This trip was supposed to take months, and it was rife with danger “from Native Americans, disease, and nasty weather.” The party was informed by an explorer that there was an easier way to get to their destination that could save them a few days. This advice was wrong, and it led them through the desert in the summer and through the mountains in the middle of winter. There were 81 people in the party, half of whom were minors. The mountains proved impassable at times, and the people were at risk of starvation. In order to survive, members of the party ate the flesh of those who died. Housel uses the story of the Donner party to exemplify what can happen when people seek out shortcuts.

Housel understands that pain is inherent in life, and he looks to the movie *Lawrence of Arabia* for a solution: “the trick is not minding that it hurts.” He believes in the importance of enduring pain rather than trying to find a shortcut around it. While he understands the appeal of hacks, he believes it is far better to put in the hard work and insist on quality rather than relying on shortcuts to get a person where they want to go. He refers to people who excel in their fields, like Jerry Seinfeld and Michael Jordan, and uses them to prove that excelling is hard and that it requires a lot of work. He quotes Seinfeld as saying, “If you’re efficient, you’re doing it the wrong way. The right way is the hard way. The show was successful because I micromanaged it – every word, every line, every take, every edit, every casting.” Housel believes that the most important things in life come with overhead costs, and people need to realize that if they want to acquire or achieve these things, this price must be paid.

Towards the end of Housel’s list of the unchangeable is the propensity he sees in humans to seek complexity. He claims that people will often eschew simplicity, even when it is effective, and instead opt for complexity. An example of this can be seen in cancer treatment. Housel discusses how cancer treatment is often placed above cancer prevention. He believes that focusing on cancer prevention would be “the next big leg up on the war on cancer,” but people instead focus on treatment because “prevention is boring.”

Housel details some reasons why he believes people are drawn to the complex. One of these is that he believes complexity gives people a sense of control. He believes that often only a few variables are implicit in leading to most outcomes. People fear being viewed as ignorant, however, if they only focus on those few variables, so they tinker in complexity. He then goes on to discuss how many people do not finish reading

most nonfiction books. The average nonfiction book, he says, is about 250 pages. He attributes this long length to a writer’s desire to look like he or she understands the topic fully. Therefore, the extra material is included in order to bolster the author’s perceived expertise so the reader considers the few important points the author makes to be credible. Housel ends this chapter by saying, “But a truth that applies to almost every field is that there are no points awarded for difficulty. It’s possible to try too hard, to be too attracted to complexity, and doing so can backfire spectacularly.”

Morgan Housel begins his book, *Same As Ever*, by telling his reader how important it is to focus on those principles in life and in the course of humanity that do not change. He then goes on to share over two dozen of these principles with his reader. Each of his principles is discussed in length, and the book’s readability can be attributed to the manner in which Housel incorporates stories and numerous examples to illustrate each of these points. He ends his book by sharing Eleanor Roosevelt’s thoughts on the eve of D-Day. She told her husband that it seems absurd to be their age and still be uncertain about the future. Housel believes that this uncertainty about the future is only human. Therefore, he believes in looking back towards the past to what has remained unchanged. He explains that he made a vow to read more about history, and the more he did so, the more he became comfortable with the future. This is because history can point to what does not change. This is what can direct people to the future.

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Straight to the Bottom Line



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Straight to the Bottom Line®

An Executive's Roadmap to World Class Supply Management

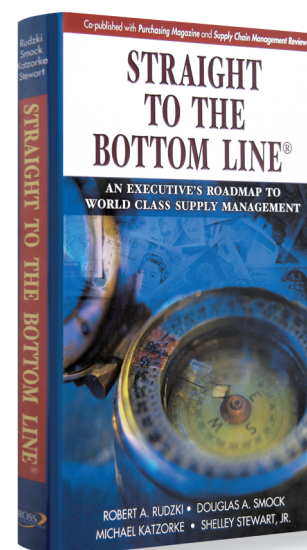
THE SUMMARY IN BRIEF

First, purchasing and procurement moved from a simple negotiation practice to a strategic interface with external resources. Next, procurement moved from simple procurement (dealing with discounts) to supply management (dealing with the optimization of supplier relationships). *Straight to the Bottom Line* highlights these new, valuable perspectives and enables senior corporate executives to turn the enormous top-line and bottom-line potential of supply chain and procurement into reality. By following the straightforward principles of *Straight to the Bottom Line*, senior corporate executives can improve performance quarter-to-quarter and year-to-year.

In addition, the authors explain the contributions that supply management can make to corporate success, and how managers and executives can achieve these goals. They also present a step-by-step roadmap for senior executives on how to implement a supply management transformation that quickly drives significant savings to the bottom line.

IN THIS SUMMARY, YOU WILL LEARN:

- How to optimize performance by using rapidly improving software for supplier negotiations, spend analysis and contract management.
- How modern supply management can improve ROIC.
- How to address the problems and concerns of executives, procurement managers and their teams.
- How to increase shareholder value through better procurement/supply base management.
- How to transform your purchasing department into a strategic supply management operation that adds value up and down the supply chain.



by Robert A. Rudzki,
Douglas A. Smock,
Michael Katzorke and
Shelley Stewart Jr.

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THE COMPLETE SUMMARY: STRAIGHT TO THE BOTTOM LINE®

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Executive Assessment: Pre-Transformation

In smart companies today, purchasing is a part of the holistic corporate function and strategy and is not treated as a stand-alone function. Nor are engineering, manufacturing, logistics and sales. They are all marshaled to address a company's cost structure — as well as its top-line growth.

Smart companies tap the power of their supply base, not only for best-in-class technological innovation but also for supply chain improvements that can dramatically improve return on invested capital (ROIC) through actions to improve revenues, reduce costs and improve the capital intensity of the business. A key driver for improving shareholder value is to ensure that the ROIC exceeds the company's cost of capital. Modern supply management can improve ROIC in many ways, including actions to improve margins and actions to improve asset utilization.

The reality in Western business is that only a few companies have both assigned a strategic role to purchasing and sustained that role over time. Other companies have assigned a strategic role to purchasing for a period of time, or until a new corporate priority (or fad) moves into the top slot. Most companies have not yet fully realized the enormous opportunity this purchasing offers.

The Tools

For the most part, the tools for success are available to everyone.

The big challenge seems to be internal to the organization itself. Key executive-office issues are a lack of understanding of the opportunity presented by improved supply-side performance; lack of active support for purchasing; poor choice of leader for the purchasing function; incorrect reporting relationship between the chief procurement officer and the executive suite; a lack of alignment between corporate, financial and purchasing objectives; and, most important, a weak or totally lacking mandate.

The purchasing issues include problems created when the top person is not a true leader, skill sets are missing or deficient, purchasing objectives are not shared with other key stakeholder departments (such as operations or engineering), and best practices are not understood or embraced.

Corporate Profitability

Purchasing, or more broadly supply chain management, can play a significant role in boosting corporate profitability.

Organizations that have achieved significant performance breakthroughs have first come to understand and believe that purchasing can have an enormous impact on a company's total performance. And then they have fundamentally redefined the role of purchasing in their company. That new role is characterized by the following:

- Purchasing is an ongoing corporate priority.
- Reports to a senior executive officer.



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- Has a clear, strong mandate to effect transformation and change in the organization's supply chain and procurement practices and to impact return on investment directly.
- Has a clear mandate to manage all supplier discussions, negotiations and selections and to control all external spending.
- Has objectives that are part of the corporate priorities.
- Leads cross-functional teams that cross all internal "boundaries" and can itself contribute to culture improvement within an organization.
- Can serve as the "eyes and ears" for the organization, due to purchasing's unique position of interacting with many suppliers from many industries; in this role, purchasing can play a key role in identifying competitive opportunities and threats.
- Leads the effort to tap the resources and competencies of current and prospective suppliers.

The Benefits

The benefits of purchasing playing that new role — as demonstrated by leading organizations — are nothing short of competitive advantage and outstanding business performance improvement in the following areas: cost structure, organizational discipline, return on assets, asset recovery, risk management, compliance and governance, customer satisfaction, supply chain efficiencies and cycle times, product development cycle times, reduced capital investments, top-line revenue growth, and increased stockholder value.

Once you have committed to the concept that supply-side management is a critical component of corporate success, the most important steps are:

1. Establish clear and measurable goals.
2. Make sure that purchasing — or more broadly supply chain management — is appropriately aligned in the company.
3. Make correct corporate structure part and parcel of the process (centralized, decentralized or hybrid).
4. Put a leader in place who can implement the change you desire.
5. Ensure that you have the right tools and training in place.
6. Last, measure performance on a regular basis. ●

An Executive Roadmap

The business world is a battle of global supply chains. One is pitted against the other. Your entire

supply chain must be aligned with appropriate goals and measurements.

To start, goals for supply management must meet the normal management accepted wisdom. They must be SMART: specific, measurable, attainable, relevant and time sensitive. Add an extra S for stretch — attainable, but with a very strong effort.

Second, you must assess where you stand relative to your competitors and best-in-class standards, regardless of the business you are in. Best-in-class companies achieve significant cost and quality advantages over their competitors.

The Endgame

The endgame, of course, is cost performance and predictable, sustainable returns that please your shareholders. But there are many ways to achieve those goals. Most chief purchasing officers work to meet annual cost targets, typically reductions of 3 to 4 percent. The IBM purchasing group is expected to report 5 percent better than best-in-class net of all price changes. That is an ambitious, unambiguous challenge. Make your purchasing people stretch.

Experts recommend a three- to five-year overall cost reduction target that is mutually owned by purchasing and other stakeholders, such as manufacturing, engineering, R&D, information technology and finance. It goes without saying that achievement of that target requires significant investment in capital, brainpower and personal commitment.

Expectations

Make your expectations realistic, but tough. Setting stretch objectives involves an honest internal assessment of where you stand in comparison to what other companies in similar situations have achieved, and then the establishment of a few measurable "wow" objectives.

Pick three to five goals, or sets of expectations, starting with cost. All cost savings should be hard — and verified by a finance officer and the stakeholders in the business units. The standard approach is cost this year versus the previous year ("year-over-year").

Here are two examples of top-line and bottom-line objectives:

1. New product development cycle time:

Would reducing the time from product concept to shipping that new product improve your competitive standing and win new sales? Can you reduce that cycle time by 50 percent and get to market before your competitors while also reducing total cost of sourcing and manufacturing?

2. Total cost of ownership. This relates to reducing not just the purchasing acquisition costs but also the “cost in use” during the manufacturing and shipping process, including costs of returns and defects. R&D, operations, quality assurance and logistics can all participate in selecting the right suppliers, the right material specification, etc. Everyone who is a stakeholder in the process must be a participant in the objectives as well, with something at stake (e.g., their annual bonus).

These are good stretch objectives that make a real difference to the business and have a direct impact on improving return on invested capital.

Supply Management's Role

The term *supply management* refers to the concept of purchasing as a strategic, supplier-facing function. *Supply chain management* is the management of materials, services and products all the way from extraction of ore to the delivery of products to the final customer. Supply managers operate as a key functional group in the supply chain and sometimes even run the supply chain. The terms supply management and supply chain management are often used incorrectly as synonyms.

We need to begin supply chain process transformation by looking at the work — the process, and then the people, and then the organizational structure.

Purchasing is a process within a business. It has inputs and outputs. For every input, there is a human source. For every output, there is a customer. These are the stakeholders in the process, and for optimal performance these stakeholders must be integrated into the process, not merely passive observers of it.

Pick the Right Leader

You need to be very careful in the appointment of your next chief procurement officer.

There are many factors to consider when making this selection, but the most important is the candidate's ability to work with and lead people. Your new CPO will not be a czar; he or she will be a team leader. And first and foremost, he or she must be able to attract and retain a cast of extremely talented and highly motivated people. No particular skill set is critical because the required skill sets will constantly change. Furthermore, the ideal leader will also have cross-functional work experience and be a well-rounded businessperson, be credible with key constituents such as operations and finance, and be comfortable interacting with the CEO's office and the board of directors.

Corporate Structure: Lead from the Center

In the 21st century, it has become clearer that purchasing is a game-changer and needs to become a serious part of the structure conversation.

There are three common types of procurement organization structures:

- **Centralized:** The leader normally has a title of CPO or senior vice president of supply or purchasing and has formal profit-and-loss responsibility.
- **Decentralized:** This can be led at either the plant or the business unit level. In centralized systems, purchasing often reports through finance; in decentralized systems, purchasing often reports through manufacturing or operations. This approach is more plant focused and tactical.
- **Hybrid:** Often called “center led,” this approach can capture close to full benefits of a centralized system and avoid serious disruption of corporate culture. Normally led by a CPO or senior vice president of supply, the hybrid structure includes a small corporate purchasing staff that establishes policy, coordinates cross-enterprise strategic sourcing teams, provides training, and establishes standards in ethics and stewardship.

Innovation and Technology

One definition of a best-in-class purchasing organization is willingness to innovate.

Successful early use of a winning supply chain technology tool can lead to significant competitive advantage.

Technology is defined here primarily as automation and application of computer software to purchasing disciplines.

As a CEO or other senior corporate executive, it is most important to make sure your supply chain team is aware of the latest innovations in software and how they can improve purchasing performance. Make innovation in supply chain one of six or so key areas that you monitor with your chief procurement officer on a quarterly basis and that you personally support.

Establish meaningful metrics to measure its performance. Make sure each piece fits into a long-term puzzle. And remember that your basic purchasing approach must be in good shape before you can order a technology implementation.

Measurement and Expectations

The key to having a credible measurement of cost reductions in purchasing spend is to realize that *three* factors must be measured and reported in order to have a net figure that is relevant to the income statement that senior executives and division presidents look at:

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initiatives (purchasing projects), volume fluctuations and marketplace factors (e.g., natural gas price fluctuations).

The total (net) of these three changes will fairly closely align with the results coming out of a company's accounting system. When this is the case, it greatly enhances purchasing's credibility.

Transformation

With key elements in place, what else do you need to have in place so that progress can continue once your initial leader moves on?

Ideally, of course, you would fill the shoes of your initial leader with another true leader. But if that is not immediately possible, it becomes even more critical that most of the elements of advanced sourcing be in place. In addition, to enhance the probability of successful and sustainable transformation, focus on these two areas:

1. **A solid and ongoing change management or business transformation process.**
2. **A financially linked "skin-in-the-game" process.** Skin-in-the-game refers to personal commitment, and was coined by celebrated investor Warren Buffet to explain situations in which high-ranking insiders put their own money on the line to support companies.

Sustainable Transformation

A successful and sustainable transformation also requires:

- Efficiency.
- A shared need that everyone understands and a perceived benefit of adopting change to address that need.
- An exciting vision of change and what that change can mean to the organization.
- Clear communication about the vision and agreement on the approach, deployment and measurement process.
- Elimination of obstacles.
- Executive actions consistent with the vision.
- Reinforcement of the changes being adopted, typically by celebrating success.
- An integrated, rigorous leadership discipline to "stay the course" with both the plan and the change management process. ●

Post-Transformation: Best-in-Class Examples

Suppliers are corporations' most important allies in the competition of global supply chains. Curiously, it is only a

very recent development that Western companies attempted to share even very basic information with them.

When R. Gene Richter assumed the top procurement post at IBM in the 1990s, he discovered that all IBM corporate information was kept secret. Suppliers were told to make a specific part, but were never told how or where it would be used. "In procurement we were the guardians of confidential information, the guard at the door who didn't let any suppliers know anything. You couldn't have effective collaboration with suppliers... What happened is we woke up. We realized that we couldn't be experts in everything."

Richter's core point was that American business operated on a system of distrust in regard to just about everything — and especially suppliers. The new business model must be built on a foundation of long-term relationships focused on core business functions — those that are most critical to the future of your company. Identify non-core areas and apply a different model: outsourcing, out-tasking or application of electronic reverse auctions focused on price. In purchasing, supplier development is the holy grail. Another principle tenet of Richter's approach was to recruit very talented professionals and then empower them to work with suppliers and make decisions within a carefully designed framework.

Automotive Purchasing

One of the visionaries of the role of suppliers was Thomas T. Stallkamp, a procurement executive at Chrysler Corp. in the early 1990s, who invited suppliers to participate in cost reduction programs and to join in new platform design.

One of Stallkamp's key moves was development of a program called SCORE, for Supplier Cost Reduction Effort. The genesis, of course, was Chrysler's financial distress. The program was announced in 1990 to a group of the company's largest suppliers. Suppliers were asked to submit written proposals that would cut costs. Suppliers had previously submitted such ideas, but found engineering unwilling to take the time or the risk to evaluate them. The carrot was significant: Suppliers would receive half the payout from verified savings.

Robert A. Lutz, who became president of Chrysler in 1988, recalled that the most important aspect of SCORE was the symbiotic relationship between suppliers and Chrysler: "[We] were really both links in the same value-added chain — and that we could demand price cuts from suppliers till the cows came home, but if we didn't work together to get total costs out of our common chain, we'd just be fooling ourselves in the end."

Consumer Products

Procter & Gamble (P&G) created a global product supply organization in the late 1980s and built a supply chain organization that included purchasing, manufacturing, engineering and logistics. “Purchases” was organized on a global basis in 1992, even before P&G’s giant business units (such as baby care and beauty care) were organized globally. Purchases staff members were embedded in the global business units, allowing a close alignment with business goals.

Supply management is a corporate priority at P&G because it impacts about 55 percent of the company’s total revenue stream. In some business units, purchasing accounts for close to 70 percent of total delivered product costs. A 5 percent improvement in costs translates into a 20-plus percent improvement in profits. Accordingly, virtually 100 percent of external spend, including advertising, legal expenses and consulting, is supervised by purchases professionals.

Aerospace and Industrial

United Technologies Corp.’s CEO, George David, appointed Kent L. Brittan as vice president of supply management in 1996. Brittan had been chief financial officer at Otis Elevator and had a clear mandate from the CEO to seek efficiencies on the supply side.

One of Brittan’s first impulses was to eschew the concept of “purchasing.” “The word purchasing or procurement does not really describe what we do,” he said. “It’s one element. But quite frankly my job is to think about the future and give direction to the company. I interface with a lot of people in this company including engineering, manufacturing and quality. And because of UT500 [an initiative focusing on general procurement], I interface with division presidents on a regular basis. The word *purchasing* itself is an important element of what we do. Obviously the words *supply management* and *supply chain management* much better describe the function.”

Brittan used online tools to get attention and demonstrate impact, and then he lined up senior executives to champion supply change. The senior executives are actively involved on an ongoing basis. The fact that the metamorphosis took place in a highly decentralized company comprised of business units with long histories and strong character is even more impressive. ●

The ABCs of Best-in-Class Practices

Strategic sourcing is a fact-based, rigorous process that involves substantial internal data gathering and evaluation, and

Alliances

Thomas T. Stallkamp, creator of the Extended Enterprise in Chrysler procurement, wrote, “Alliances require a complete corporate focus, starting with senior management, to break the paradigm of individual companies building walls around themselves.”

extensive external data gathering and interactions, in order to select the most appropriate strategy and negotiations approach and ultimately select the right supplier. Strategic sourcing transforms conventional purchasing into a strategic process involving all appropriate stakeholders in a company and that can add significant value by reducing total costs relating to purchased goods and services.

To put strategic sourcing into perspective, it is one of three critically important elements in modern procurement: transactional execution, supplier management and strategic sourcing.

Transactional Execution

On a daily basis, there is a need for accurate and efficient transactional execution (often now referred to as just “purchasing”). Here, the focus is on easy and cost-efficient order placement (with suppliers that have been selected by strategic sourcing), order follow-through and expediting (if needed), order receiving, and order payment. In the state-of-the-art company, the end user (not a purchasing professional) places an order into a system that is populated with approved suppliers and approved materials/prices using master agreements or contracts, and that system communicates directly through electronic media with the approved supplier.

On an ongoing basis, there is supplier management, that involves the continuous and active supervision of the supply base. This includes evaluating supplier performance against criteria agreed to during the negotiations phase of the sourcing process, discussing opportunities for mutual process improvement and resolving conflicts. Some of these ongoing activities are tactical in nature; others are strategic.

On a periodic basis, there is strategic sourcing. Intensive strategic sourcing efforts often occur every three to five years for a specific spend category, with active monitoring of the supply market in between those sourcing events.

Purchasing vs. Strategic Sourcing

The distinction between the complementary functions of purchasing and strategic sourcing can be described along three dimensions:

- **The primary mission/objective:** Strategic sourcing involves leveraging the corporate spend and partnering with a small, preferred supplier base, which is capable of achieving continuous (year-over-year) improvements in cost, quality, delivery, technology and service.
- **The planning horizon:** Strategic sourcing planning horizons begin two to three months from today and can extend as far as five years or more into the future.
- **Organization structures and individual competencies:** The strategic sourcing process and activities must be organized cross-functionally to be successful with engineers, manufacturing and quality personnel, commodity managers, and financial analysts. These professionals must be competent in planning, project management, financial analysis, negotiation and cross-functional operations.

Strategic Sourcing

There are a few absolutely critical success factors for strategic sourcing. First, strategic sourcing must be part of an overall, coordinated transformation plan. With that organizational support and context, strategic sourcing has a stronger chance to succeed as an initiative and has excellent prospects for becoming an embedded business process that serves your business well into the future. Without that support and context, strategic sourcing is likely to face an uphill battle.

Strategic sourcing must also have access to cross-functional talent and resources, either through ad hoc team members borrowed from key departments and locations or, even better, through the assignment of high-potential employees to a core team role lasting two or three years. This latter idea has served companies well in terms of both strengthening the sourcing process and providing valuable developmental experiences to employees viewed as having significant upward potential in their careers.

Supplier Relationships

Three interdependent dimensions determine success in supplier partnerships. There is an operational dimension common to all forms of partnership, a cultural dimension and a strategic dimension that applies to deeper enduring relationships of high value to both parties.

In terms of operations, you want to find ways to gauge the flow of information and the compatibility of the partners' processes.

On the strategic level, the metrics will focus on the degree of business integration necessary for a continued strategic fit and on the characteristics vital to a long-term partnership.

Supplier Diversity

A strong business case can be made for supplier diversity programs. Demographics are shifting; minority groups are growing rapidly and are projected to grow even more rapidly in future years. With this in mind, many companies have concluded that sourcing with minority businesses makes sense because these groups represent an ever-expanding customer base.

The current definition of a minority or women's business enterprise (MWB) is a company that is at least 51 percent owned, controlled and operated by one or more minorities or women.

Low-Cost-Country Sourcing

Low-cost-country sourcing is also an important, but complex, tool in the arsenal of best-in-class companies.

Low-cost-country sourcing requires a strong foundation in strategic sourcing, plus strong global and regional market knowledge; an ability to monitor changing economics worldwide; a careful identification and assessment of all cost factors; and a willingness to invest time, people and money to convert the *possible* economic advantages of sourcing from (or outsourcing to) a new country into *realized* benefits.

Negotiations Management

There are three major phases to successful negotiations, and most people in their personal lives, and many corporate purchasing departments, only focus on the last phase:

- **Build a fact base.**
- **Develop a carefully thought-out and appropriate strategy.**
- **Negotiate/buy.**

Strategic sourcing is a modern, disciplined, fact-based and rigorous process. To avoid losing the benefits of the entire sourcing process, the negotiations management process must be equally rigorous and fact-based in its development and execution.

Contract Management

A key ingredient in approaching sourcing and negotiations in a more strategic manner is to plan ahead. Sometimes that means initiating the market analysis phase of strategic sourcing *far ahead* of the contract expiration.

Good contract management includes information that allows you to know with certainty the expiration dates of all commitments to every supplier, provides easy access to the commercial terms of current contracts and enables you to plan ahead.

Risk Management

Successful risk management involves proactively identifying and managing risks, with a focus on minimizing the potential financial impact on the corporation. For each corporation, there is some level of risk that the corporation is willing and able to assume (sometimes called the corporate risk retention level). The capability of the corporation to assume risk is heavily influenced by its capital structure, liquidity and business outlook.

Financial risk management is typically called *hedging*. It is probably appropriate for every corporation to do certain amounts and types of financial risk management. Hedging is a strategy used to offset (and thereby reduce) risk, generally accomplished with options (caps), swaps or costless collars (which often have no up-front costs, the upside cost is capped and the downside price is set). A perfect hedge is one which eliminates the possibility of future (additional) gain or loss by exactly offsetting the exposure being hedged. Most hedges are imperfect to varying degrees.

The primary objective of hedging is to reduce volatility and earnings at risk. In many cases, companies that hedge do so to “lock in” prices at or near their business plan levels.

Consultants

There is nothing inherently evil about consultants, but they are not often managed well by the client.

The client should do its homework and carefully select the consulting firm for its niche of expertise, carefully task the consultant, properly compensate the consultant with well-thought-out at-risk incentive arrangements and manage the program/project engagement actively. If the client does all of these things, real benefit can result for both parties.

Outsourcing

Business process outsourcing (BPO) is defined by Gartner as “the delegation of one or more IT-intensive business processes to an external provider that in turn owns, administers and manages the selected process based on defined and measurable performance criteria.”

While the term BPO is a relatively recent development, BPO has actually been in practice for many years in one form or another. Perhaps the earliest example in the procurement arena is in travel.

There are two approaches that have emerged. Some companies do their own deals with hotels, airlines and rental car companies, but utilize a credit-card provider that administers the use of the program. This amounts to “partial outsourcing” of travel. In other cases, companies

Supplier Recognition

Most supplier recognitions for one calendar year occur in April or May of the following year. This is due to the time required to assemble final performance data for the year just ended; time needed to consider all potential nominees; time to prepare the nominations and review them against established criteria; lead time to advise the selected suppliers; and lead times to prepare program materials, print ads for publications, etc.

have effectively outsourced their entire travel program to a professional travel services firm. The benefits of doing so have been straightforward: You can leverage the market expertise of a firm whose entire business is devoted to understanding the intricacies of the particular marketplace and also achieve operational efficiencies by employing the service provider’s technology/systems in-house. Today’s BPO services providers suggest that the benefits of BPO in procurement include these two basic benefits plus other benefits as well.

The objective is to have a recognition ceremony (the “awards ceremony”) that in itself is memorable for your selected suppliers. The ceremony, combined with press releases and selectively placed print ads that publicly recognize your premium suppliers, will generate enormous goodwill with your chosen premium suppliers and give them strong incentive to work hard to earn an invitation to return the following year.

Epilogue

Of course, excellent procurement and supply management is not the only reason that businesses succeed or fail in the long term. However, it is a necessary and critical component. Without excellent procurement and supply management, a company cannot hope to excel in meeting the tough performance expectations of today’s unforgiving business world. ●

RECOMMENDED READING LIST

If you liked *Straight to the Bottom Line*, you’ll also like:

1. ***The Change Masters* by Rosabeth Moss Kanter.** Have trouble adapting to organizational changes/ This summary, aimed at corporate officials, shows how changes are necessary — and can be profitable.
2. ***Reengineering the Corporation* by Michael Hammer and James Champy.** Forget about incremental improvement. Here’s how to make quantum leaps in performance by analyzing and redesigning your work practices.
3. ***Tough Management* by Chuck Martin.** Are you faced with shrinking budgets, smaller staffs, shorter deadlines and more demanding customers? You need business strategist Chuck Martin’s fresh, bottom-line approach designed for what really works in today’s business environment.

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Summary

The New Frontier in Oil for Investors Black Gold

THE SUMMARY IN BRIEF

Fossil fuels are the dominant energy source fueling the modern economy, and at least in the short term they will continue to shape our society in the new millennium. There are close to two trillion barrels of proven oil equivalent (boe) stored in rocks around the world, both on- and offshore. In terms of consumption, the United States uses 20 million barrels per day, or 25 percent of the world total, and imports about 60 percent of its oil needs, mostly from Canada, Saudi Arabia, Venezuela, Mexico and Nigeria, in that order.

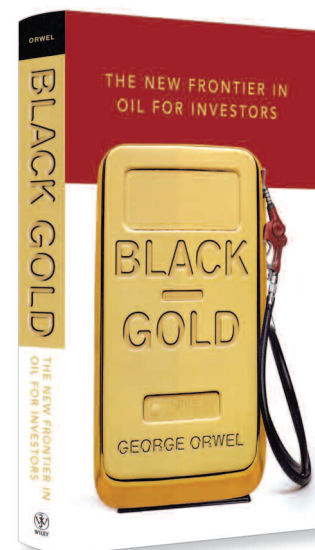
It is essential to understand how important oil is to our way of life. Oil provides gasoline that powers automobile engines, but we depend on oil for other things as well. About 90 percent of the organic chemicals we use are made from petroleum. These include pharmaceuticals, agricultural chemicals and plastics — all byproducts of oil. As oil prices rise, so do the prices of oil products.

Oil prices started their steep climb in 2004 because of four factors: first, rapidly growing demand from China and India; secondly, the world's major oil-producing countries, mostly in the politically volatile Middle East, have almost maximized their output and have no spare capacity; third, geopolitical tensions have become common, disrupting supply from Venezuela, Nigeria, Russia and the Middle East; and fourth, oil and gas are becoming viable investment vehicles for those seeking wealth.

Major oil companies such as Exxon Mobil, BP and Valero have displaced Microsoft, AOL Time Warner and General Electric from the high table of capitalism. However, instead of mourning the tight market, investors should actually embrace it, at least for now, because there are several years ahead to enjoy the boom. Oil stocks, whether in oil exploration or refining companies, are doing so well that market analysts discount any possibility of a meltdown.

IN THIS SUMMARY, YOU WILL LEARN:

- The basics of the oil industry.
- The consequences of an oil peak for today's society.
- The possibilities that alternative fuels offer.
- Why energy is such a hot commodity.
- How to benefit from high oil prices as an investor.



by George Orwell

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THE COMPLETE SUMMARY: BLACK GOLD

by George Orwell

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The End Of An Era?

With oil prices on a stratospheric flight, many traders and investors are finally taking notice. The stock market already is: Oil stocks were higher than other equities in 2006. The oil stock gains have been seen all around the world, not just in the United States. Everyone, from professional economists on Wall Street to ordinary consumers, has been wondering why oil prices are so high and continue to rise. For an answer, they should look no further than economics, geology and politics.

While oil demand is rising, supply is struggling to keep pace. The availability of cheaply exploited oil has been reduced. There are still a lot of oil reserves in some parts of the world, like in the deep waters off West Africa, in arctic Russia and in the Middle East, but there are problems as well: The cost of drilling in hard-to-reach areas like the offshore Black Sea, the Gulf of Guinea and the Gulf of Mexico is sometimes prohibitive and superior technology is required; security is tenuous in places like Iran, Iraq and Saudi Arabia; and most of the readily available oil is of the low-quality heavy, sour type, which is expensive to process into gasoline and other products. High-quality light, sweet oil, which yields more gasoline, is in short supply, and most of the old refineries in existence have not been fitted with coking units that can process the heavier crude.

Another problem is that since the early 1990s, oil companies have not invested enough in expanding their infrastructural capacity, both in oil production and in refining. Oil executives say they couldn't invest because they had no money, as oil prices were low until the shock demand of 2004 boosted prices. They say the high oil prices have given them a shot in the arm, and a number of projects are in the pipeline — however, these

projects will take time to come onstream.

An Oil Debate That May Determine Who is Top Dog

You should know from the outset that whenever experts talk of an oil peak, what they generally mean is that from then on, production will gradually slide down the slope toward the last drops at the rate of about 2 percent annually. The current oil-peak debate started around 1995 but stayed off the radar because it was drowned by the tech boom of that decade. Moreover, oil-peak theorists have warned that the decline of world oil output will force oil prices higher for good, the effects of which could be catastrophic.

However, it should be noted that the amount of oil that is recoverable under normal conditions also varies by each type of field. Some fields end up recovering as much as 65 to 80 percent, while others get as little as 10 to 20 percent recovery. The total reserves also include high-quality light sweet oil commingled with low-quality heavy, sour oil.

So, whom should you believe if world oil is really running dry? Those who reject the oil-peak theory have a lot of faith in technology; they argue that new technologies — and higher prices — are going to make it possible to suck oil out of unconventional places.

For instance, extracting oil from tar sands was once thought to be prohibitively costly, but currently oil from Canadian tar sands sells for approximately \$20 per barrel. Canada puts its reserves at 300 billion barrels, higher than even Saudi Arabia, though much of that is unrecoverable.

That's why along with the debate about oil peak, there should be proposals to promote renewable fuel sources



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— green energy. However, many of these alternative fuel sources only provide supplemental solutions that have a limited impact at a time when lasting solutions are needed. Although oil is known mostly for producing transportation fuels, it's not an exaggeration to say that it literally drives the planet.

Energy Economics

Since 1972, the inflation-adjusted price for a barrel of oil has averaged \$34, and while higher oil prices will depress demand, even in a classical economic model, the price of oil has to average an inflation-adjusted \$60 per barrel before oil consumption/production actually declines year over year. Between 1980 and 1984, oil output declined for four consecutive years as the inflation-adjusted price averaged \$69 per barrel. In 1984, as the price declined to an average of \$50 per barrel, output once again began to increase and increased each year since. Demand hasn't suffered in the current situation because family incomes are just as high and energy now represents only a tiny bit of family spending in the United States. All of this makes estimating the remaining lifespan of the world's oil and equivalents supply a tricky business.

Supply and Demand

There are 38 major oil-producing countries, of which only 11 are OPEC members. These 38 producers and many other minor producers are sitting on the 1.2 trillion barrels of oil and 885 million boe of natural gas reserves. However, there is no real agreement on how large these oil reserves really are; what is uncontested is that reserves are being found at a much lower rate than they are being consumed. Even more important is that current daily supply and demand for oil are so tightly matched that there's no room for error.

In 2003, demand from the developed world, especially the United States, was just as robust as China's, and that trend intensified in 2004, flattened in 2005 and recovered in 2006. Moreover, oil demand from the rest of Asia, particularly India, South Korea, Taiwan, Thailand and Singapore soared as well.

On the supply front, there are three things to consider:

1. The rate at which non-OPEC production capacity is growing.
2. The potential for growth in OPEC production capacity is becoming increasingly smaller. At the moment, most of the OPEC members, with the exception of Saudi Arabia, are operating at near capacity.

3. How effective OPEC has been in managing supply.

Long-Term Outlook

Over the last 30 years, daily oil consumption has risen by approximately 30 million barrels, just under one million barrels per day each year, according to the International Energy Agency (IEA). In recent years, over one-half of the growth in demand has come from Asia. Asian demand — particularly China, India and South Korea — has grown by 10 million barrels daily in the last 17 years.

The Hubbert Curve

As a framework for thinking about the world's oil production and supply, it is useful to understand the work of Marion King Hubbert, the Shell geologist who in 1956 correctly predicted that U.S. oil production would peak around 1966–1972. Oil analysts have applied Hubbert's methodology to world oil production and are predicting that world oil production will peak within the next several years, though they disagree on the precise timing. Hubbert's technique was based on the prediction that the production level for oil as it was utilized would follow a normal distribution. Thus, if the United States had 200 billion barrels of reserves when 100 billion barrels had been extracted, U.S. production would begin to decline.

Assuming that the world originally had three trillion barrels of oil reserves, if two trillion had been discovered thus far and one trillion has already been consumed, then one trillion barrels would remain to be discovered. A peaking of oil production would occur after another one-half trillion barrels had been consumed, and this would probably occur in about 15 years, according to this analysis.

It is worth noting that Hubbert's methodology is based on a purely statistical analysis of exploration and production data. It does not take into account new developments like tar sands, which could potentially prolong oil supplies for a few decades, nor does it take into consideration emerging advanced production technologies. Still, Hubbert's theory is important because it provides a road map for the oil market; if demand is set to rise to 100 million barrels per day and there isn't the production capacity to match, oil prices can only move in one direction: up. ●

Consequences Of An Oil Peak

Civilization has gotten to a point where it is almost impossible to imagine life without cars, air-conditioned

rooms, hot showers and electric appliances. And yet, there's a growing realization that such habits need to change because it takes a lot of limited resources to produce and run all the machines that make life easy and comfortable. All advances and problems are now manifested in rising fuel prices; the strain is felt at the gasoline pumps and in home heating bills.

At the moment, about 80 percent of all the energy used in the United States comes from fossil fuels — oil, coal and natural gas. Nuclear power provides 10 percent of the energy and the remaining 1 percent comes from renewable fuels — sun, wind and water, according to the U.S. Department of Energy (DOE). Oil prices, which skyrocketed from \$18 to \$75 per barrel in just four years, are not likely to get much lower in the long run, so we might as well get used to them.

In time, we may learn to love the aftermath of the pain. That's because as investors we are going to make money out of the situation, and in the long run we'll also find other ways of living without Middle East oil.

Neglecting Future Problems Is a Failure of Leadership

Aside from taking measures to raise the fuel-efficiency standards for vehicles as a part of a broader effort to control explosive demand growth, the U.S. government also needs to come up with a more imaginative and creative national energy policy that would not only encourage energy conservation and diversify supply, but would also jump-start a major national initiative to cut the country's dependence on foreign oil.

The federal government's inability to enact a broad energy policy to create alternative energy sources at least three decades ago has been justifiably called the biggest single U.S. policy failure of the past half-century; it has made the United States vulnerable to oil shocks from abroad.

Consumption, En Masse

Clearly, change isn't going to happen overnight for the United States. The automobile industry is one of the most energy-intensive modes of transportation ever created. Car ownership in the United States, at 217 million, is the highest in the world. Because of urban sprawl in the south and west, in places such as California and Arizona, there is a social dependency on car transportation.

The highway system, which was built in the 1950s, has only encouraged this urge to drive in a huge car alone. Millions of gallons of gasoline are being used in this

Types of Renewable Fuels:

Solar Energy — energy that radiates to the earth from the sun; solar thermal devices concentrate it in some manner to produce heat at useful temps

Wind Energy — kinetic energy from the wind is harnessed by turbines to generate electricity

Biomass — from three distinct energy sources: wood, waste, and alcohol fuels; includes biomass alcohol fuel or ethanol derived from corn

Municipal Waste — waste-to-energy combustion and landfill gas; methane is combusted for energy

Wood — generates electric power, thermal output

Nuclear Energy — from nuclear fission, which produces energy by splitting atoms

Geothermal Power — energy from the earth brought to the surface by hot water or steam

Hydroelectric Power — water used by electric utilities to generate electric power

Fusion Energy — fusion reactors create energy by fusing atoms; requires 100 million degrees

Natural Gas — drilling for natural gas has surpassed oil in U.S.; net energy is equal to that of oil

Coal — enjoying a resurgence due to gasification which makes it easier to transport; coal supply is abundant yet challenges exist regarding transportation, safety and the environment.

process. The United States might be well-advised to start moving toward a mass-transit system even in cities that currently don't have one. The reason is simple: The need to conserve fuel is becoming greater by the year.

As for other uses of energy, according to the U.S. Energy Information Administration (EIA), residential energy use accounts for 21 percent of total national consumption, of which 51 percent is for home heating, 19 percent for water heating and meal preparation and 4 percent for air conditioning. The rest powers lights and appliances such as refrigerators.

In the developing world, most of the energy supply comes from coal, wood and dry animal waste or biofuel. Would North America be really happy with such an inefficient energy supply? That's very unlikely, especially since computers and the Internet are indirectly powered by fossil fuels. A lack of oil would shift demand away and to other sources, eventually causing the alternative fuel prices to go up. In the long run, information systems would be more difficult to expand and maintain. ●

Alternative Fuels

The Paris-based International Energy Agency (IEA), an energy watchdog for industrialized countries, estimates that over \$1 trillion will be invested in non-hydro renewable technology worldwide by 2030. Though oil still has an edge due to its versatility, many activists in the environmental movement have been touting renewable fuels as the key to energy security.

One thing that must be acknowledged is that the transition to alternative fuels is necessary, but it won't be easy. It will involve more financial resources and time. Not all fuels are interchangeable, and most renewable fuels have lower fuel yields than fossil fuel. There is still no battery that can move farm machinery in the fields. Some sources of oil, such as tar sands found in Canada and heavy oil in the Orinoco Belt in Venezuela, require a lot more energy to produce, so much that in the end their net energy recovery is less.

Consumption of biofuel — which comprises ethanol and biodiesel or vegetable oil — in transport has risen in recent years; ethanol in particular is expanding in Brazil and the United States. Technologies such as wind, solar, biofuel and geothermal now provide up to 6 percent of the world's total energy, according to the EIA. ●

Is the Saudi Oil Supply Adequate?

As the world's largest producer, Saudi Arabia is the single most important oil supplier and is the major driving force within OPEC. Even more crucial, it is the only oil supplier with a spare capacity of between 1.5 million and 2 million barrels per day, which gives Saudi Arabia a small arsenal to fight higher oil prices during certain limited occasions. In an oil market where supply is very tight, having any spare capacity, as the Saudis do, is golden.

Currently the kingdom is enjoying its hugest oil boom, with revenues for 2005 at \$156.8 billion, according to Saudi officials. Saudi Arabia has the capacity to produce up to about 11 million barrels per day, but actual production usually ranges from 9 million to 10 million barrels per day. Some two-thirds of Saudi reserves are considered "light" or "extra light" grades of oil, with the rest either "medium" or "heavy." Lighter grades generally are produced onshore, while medium and heavy grades come mainly from offshore fields.

Saudi Arabia's long-term goal is to further develop

its lighter crude reserves. In the spring of 2005, the kingdom announced plans to increase its oil production capacity significantly. Coming at a time of tight oil supply and high fuel prices undermining economic growth, the U.S. government openly embraced the Saudi plan, but privately, they are skeptical about some of those forecasts.

U.S. leaders have always looked to Saudi Arabia to produce more oil so as to keep fuel prices from rising and becoming a political issue. But there are many within and outside the U.S. government who now doubt Saudi Arabia's ability to keep its promise of expanding capacity. ●

Why and How Oil Prices Soared

The world is experiencing its first demand crisis in more than two decades. Blame can be placed on China, OPEC, Iraq and the oil peak, but it also must be admitted that the industry has gone through structural changes that have had enormous influences on energy prices.

How the Oil Market Works

Commodity prices are a function of demand and supply; but today's market is responding to additional pressures — geopolitical tensions as well as speculative activity. Current daily oil production of about 84 million barrels globally leaves approximately two million barrels of spare capacity, hardly enough to absorb any unplanned disruptions in the supply chain. And yet there have been and will continue to be many disruptions, especially in oil-producing countries that are politically unstable.

Obviously, such a tight market causes oil and natural gas prices to soar, as seen in 2004. When you add unexpectedly destructive natural disasters like Hurricanes Katrina and Rita, the pain becomes almost unbearable. Since 2004, oil prices have spiked in a manner that hasn't been seen since the last oil shock in 1979.

Hedging Against High Prices

Crude oil and its products, such as gasoline, heating oil, diesel and kerosene/jet fuel are traded both on a spot basis and on the futures contract basis. The futures market is basically a market for risk management, where traders sell contracts for crude cargoes that will be delivered at a later date, typically two months to many months out, through 2011. As oil prices become more volatile, those whose business involves producing, mar-

keting or using oil, gasoline and other types of energy use have resorted to managing their financial risks by buying contracts for oil and product deliveries many months or years in advance.

Tight Refining Capacity Will Keep Prices High

If there's anything to remember from Hurricanes Katrina and Rita, besides the human toll in New Orleans, it's the impact they both had on the nation's oil-refining capacity. Much of the price spike that was witnessed was due to the fact that up to a quarter of U.S. refining capacity was wiped out for several weeks. The country was able to deal with the shutdown of offshore oil production, but was unable to deal with a large reduction in refining capacity. The reason: Since the oil shocks of the 1970s, the U.S. government has always kept about 700 million barrels of oil in underground salt storage in Louisiana for emergency supply, known as the Strategic Petroleum Reserve. But the country can't import gasoline from everywhere because of strict environmental regulations.

But even before Katrina, the United States already had a refining capacity problem. There have not been any new refineries built in the last 30 years. In 1980, there were about 425 refineries; currently there are only 147. Many refineries failed in the intervening years when refining wasn't a profitable business. Those 147 refineries can process only 17 to 20 million barrels a day of crude into gasoline. That's not enough

for the 217 million automobiles registered in the United States, so about one million barrels of gasoline has to be imported every day, or 30 million barrels a month, to get along. ●

Bumper Harvest For Oil Majors

At the end of January 2006, Exxon Mobil reported profits of \$36.13 billion and revenues totaling \$371 billion for 2005, up 40 percent over 2004. To put it into context, it's more than what Coca-Cola Co., Intel Corp. and Time Warner, Inc. together earn in an entire year.

To put everything into perspective, from a stock price of \$12 per share in 1990 to about \$60 a share 15 years later, Exxon Mobil has grown fivefold, compared with Coca-Cola's share price, which rose from \$11 to \$42 a share during the same 15-year period, while Time Warner's share price rose from less than \$1 [in 1992, after the merger with AOL] to about \$17 a share.

Smaller oil companies haven't been left behind either, especially refiners. Among these, Valero Corp. and Sunoco Inc. represent different business approaches.

Valero Corp.

Valero specializes in refining dirty low-grade oil — heavy sour crude — that is found mostly in Latin America and the Middle East. Sour crude has the advantage of being easy to get and cheaper for a refiner to buy in the market, but it is also very difficult and costly to refine. The refiner's stock price, which was trading at \$104 a share in December 2005, has roughly doubled since January 2006 and has increased about seven times during a five year period.

Sunoco Inc.

Sunoco specializes in refining the pricier high-grade oil — light sweet crude — found mostly in the U.S. Gulf of Mexico, Canada, West Africa and Europe. Sweet crude is very expensive to buy and also difficult to find, but it is very cheap to refine and yields a lot more gasoline, kerosene and jet fuel.

Oil Companies Raise Capital Spending to Increase Capacity

In 2005, oil companies spent about \$86 billion on capital expenditures in the United States, up from \$81 billion in 2004 and \$76 billion in 2003, according to the American Petroleum Institute, the industry's lobby in Washington.

Nonetheless, there are other reasons why capital spending should continue to rise. Oil companies are valued on Wall Street in most part by their oil and natural

Murti and the Super-Spike

In the spring of 2005, Arjun N. Murti, an analyst with Goldman, Sachs & Co., released a report forecasting a "super-spike," with prices rising to \$105 per barrel. It was a shocker to the oil community since oil was trading at \$54 at the time; many analysts condemned it as far-fetched.

But that was before Katrina, which sent oil prices up 20 percent to \$70 per barrel within five months. So, it turns out after Katrina that Murti may have been right after all. Murti has become something of a prophet in the industry. Murti's super-spike theory was based on an assumption of a continued tight balance between global supply and demand, plus the likelihood that a supply disruption could occur anytime overseas, upsetting the market. It only missed one thing: that the disruption occurred in the United States.

gas reserves. As long as earnings remain strong, the companies will be forced to replace the crude they pump out of the ground, because they'll go out of business if they don't. That requires taking some risks — financial, logistical, political and marketwise.

Analysts See Upside in Booming Oil

Convinced that there's more upside in the booming oil industry, Prudential Equity Group has initiated coverage of major oil companies with a favorable overall rating, based on the strength of the underlying energy market. Among market trends pointing toward sustained growth are the resurgent U.S. demand for refined petroleum products, and the likelihood of continued strong natural gas prices. Similarly, Morgan Stanley forecast an upside to earnings in 2006 for several European oil companies, driven by refining margins. The firm favored Poland's PKN Orlen, MOL Hungarian Oil and Gas, Spain's Repsol and the Anglo-Dutch giant Royal Dutch Shell for their exposure to margin gains from refining. ●

The New Frontier In Oil Investments

There's been a great deal of talk about the energy crisis. You should by now be aware of the gloom and doom forecast by some very smart people for the end of oil. Also, you've heard the opposing view that some kind of solution will come through, either in the form of additional oil supply or an alternative to oil. These are both very simplistic ways of looking at the issue and virtually guarantee that nothing will be done to alleviate the problem.

However, the question you should be asking yourself is whether you are going to take advantage of the situation to save or get rich through various energy investments. Here's one important thing to know as an investor: It's a good thing to gamble, but it's even better to be sure about which market you intend to gamble in. Currently, there is no better market to invest in than energy, and it doesn't matter whether you want to invest in small cap or big cap energy stocks.

To understand why energy is such a hot commodity, look at industry trends starting in the summer of 2004, when Chinese demand hit the market and Hurricane Ivan ravaged the Gulf Coast. Then came the summer of 2005 when Hurricanes Katrina and Rita blew ashore a new energy crisis, sending crude prices to record levels above \$70 per barrel, and gasoline, heating oil and natural gas prices followed higher, increasing the

cost of almost everything from filling your car's tank to heating your home.

The Basics of Investing in Energy

First, the most fundamental reason for investing is to make more money than you get from your day job; however, buying an oil stock or two will not necessarily make you any richer instantly, nor make up for your gushing energy bills.

The type of investment you should be interested in is discretionary investments; however, like any venture, this type of investing involves risks. These risks can be dealt with though.

The first thing that you need to do is study the industry trend. Pay attention to news, both business and other types of news, because company decisions are informed by many issues, including legislative politics and technology. Currently, a useful avenue for investing in the energy industry is through an index fund like Vanguard Energy Index Fund (VENAX), which replicates a basket of stocks in a given industry. In 2005, VENAX grew nearly 40 percent, far more than Standard & Poor's 500 Index's gain of nearly 3 percent during the same period.

As an investor, don't get worried about high oil prices and the fact that they cause inflation. Let other people get anxious about such things; your job should be to use the opportunity to make money for yourself.

Don't Panic — The Boom Will Last, But Have a Plan

It's also important to time the market very well, usually before it gets red-hot, as the energy markets are now. But if you are late, don't give up; no one ever gets anything for doing nothing, so you'd be better off late than never investing in energy stocks.

Stocks are important to successful investment plans because, historically, their annual returns are double what you can get in bonds. With the U.S. inflation rate at about 3 percent, you are left with a 7 percent rate of return per year when you invest in stocks, as opposed to 2 percent when you invest in bonds. Stock investments grow faster, almost doubling every 10 years, but they are also very volatile, and you could lose money if the market goes south.

Stocks typically move up and down in five-year cycles, so long-haul investors are cushioned from market volatility. Someone who has 10 years ahead of him is different from another person with a much shorter time before he has to start spending his money. If you have a longer time frame in which to invest, look for high-return

energy stock — mostly smaller or midsize stocks — because you have time to play the market. But remember also that they are some of the most vulnerable to short-term swings. Still, you can load up most of your money in small to medium-sized company stocks. If you don't want to risk your money because you are just a few years from retirement, then consider investing in large caps and steady performers like Exxon Mobil.

One thing you should do as an investor is to develop some spine, because you are going to be taking big chances. But don't panic. The trick to smart investing is minimizing risks, while expanding opportunities for success. One sure way of doing that is by diversifying your investments. If you diversify, some of your funds will be better than others, and you'll also be cushioned from a hard landing if the market begins to dip.

Check Out Top Companies With Low P/E Ratio

The current oil boom is creating a cash-flow windfall for oil companies and that improves their fundamentals. It plays a part in the upward movement of a company's stock. You should ask yourself a few questions: "What's the health of the company and that of its stock?" "Has this company been discovered?" and "Is it an undervalued stock?" Put all of these things together and if the answers to most of these questions are positive, then you are in luck.

As an investor, don't wait it out for long once you have successfully gone through the vetting process. Look for such a company, especially one with large enough quantities of oil and gas reserves. The best ones are those with most of their reserves in North America and Europe, where political risks are low. Also, look for stocks trading at a fairly low price/earning (P/E) ratio, such as company stocks that are cheap but have high returns, because such companies have low risk, and if oil prices come off, they are more likely to profit from stock buybacks or restructuring. Such companies are also more likely to be the target of mergers and acquisitions, which increases their stock value.

The most profitable companies now happen to be refiners because the margins are so high. This means that for every barrel of crude that a refiner buys and processes into petroleum products — gasoline, diesel, jet fuel and others — the refiner gets more than \$20 in profit. The reason is that there are fewer refineries in the United States — just 147, down from 425 about 25 years ago.

Business Outlook and Balance Sheet: The Devil's in the Details

There's a broad range of oil and oil-services companies that can suit anyone's investment strategy. But you have to know first if there is growth of earnings and sales, both of which tell you whether the business is financially sound. Look at the balance sheet of each company you want to invest in and see if there's too much debt and what is the collateral for that debt, whether they are doing accounting right, whether the company has pending litigation or labor action or less insurance coverage. These are red flags for potential trouble, unless thoroughly explained.

However, if you find that you are too busy to invest in stocks on your own, then here are additional strategies to consider:

- **Mutual funds** — Try to find out what kind of managers are running the funds. The two best known commodities indexes, the Goldman Sachs Commodities Index and the Dow Jones AIG Commodities Index, are both heavily weighted toward energy, 30 percent to 40 percent. Investors who prefer small-cap companies could check out Brandywine Advisors Fund, whose portfolio is 21 percent energy stocks.
- **Exchange-traded funds** — These are low-cost funds that have become popular with investors, although they are less well understood. Like traditional funds, exchanged-traded funds (ETF) hold baskets of securities and other investments, but rather than get priced once a day, like traditional funds, they trade throughout the day like the stock market or futures market for commodities.
- **Hedge funds** — These are investment firms that try to profit by making bets on commodity and exchange futures. They buy financial instruments, or contracts, today and sell them later at higher prices and pocket the difference. They generally trade on arbitrage, or the price difference of contracts.
- **Superfunds** — Great for the smaller investor because managers charge less, typically 8.75 percent, in brokerage and management fees.
- **Private Equity** — For the wealthy investor that invests large sums of money in all manners of sectors; currently the hottest investment tools in the energy markets.

The bottom line is this: The world needs a lot of energy, but supply is getting tighter; an "uberspike" in oil prices is in the making and the potential rewards for the savvy energy investor are huge. ●

· Book 15 of 44 ·

Summary



Your Financial Guide to Retirement, Health Care, Medicare, and Long-Term Care

Boomer Or Bust

THE SUMMARY IN BRIEF

Between 1946 and 1964, 78 million baby boomers burst onto the scene in America. Since then, at every stage of their lives, America has been about them. Businesses rose to meet each of their developmental needs. Markets rose and fell according to their whims (and their disposable income). Years later, baby boomers still dominate the country. They represent 27.5 percent of the population. But they are getting old. More than 24 million of them are over 50. Soon, the boomers will be retiring, though many of them have not planned sufficiently for that eventuality. Soon, they will be dealing with Social Security. Some will soon be dealing with Medicare.

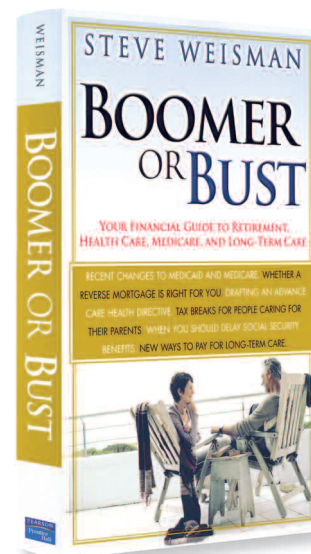
The baby boomers are also the sandwich generation with children of their own and parents who increasingly depend upon them for advice and assistance. Suddenly, they are faced with having to help parents decide about nursing homes, assisted living and home care and helping them work out their finances.

Planning for financial needs in retirement is a complex and daunting task. Because many people do not know where to start the process, they put it off. But the earlier you start the better, and it's never too late.

In *Boomer or Bust*, Steve Weisman has created a guide for baby boomers to use to empower them with knowledge so they can help themselves and their parents, and to set the stage for a better situation for their children. In simple terms he brings into focus the issues and circumstances all boomers are facing — growing old with grace and in comfort.

IN THIS SUMMARY, YOU WILL LEARN:

- What to do with your 401(k) to maximize the benefits of this savings tool.
- Other avenues of retirement investing you should know about.
- How to provide for elderly parents.
- When to start collecting Social Security.
- How to get the most out of Medicare and Medicaid



by Steve Weisman

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THE COMPLETE SUMMARY: BOOMER OR BUST

By Steve Weisman

The author: Steve Weisman is a member of the National Academy of Elder Law Attorneys and hosts the nationally syndicated radio show "A Touch of Grey." He is also a legal editor and columnist for *Talkers Magazine*.

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IRAs and 401(K)s: Retirement 'Gifts' From Congress

Two of the greatest opportunities for retirement investing are IRAs and 401(k)s. Many people, however, fail to take advantage of these gifts from Congress; many of those who do take advantage fail to do so as best they can. Knowing how to maximize the benefits of these savings tools can help make your retirement so much better.

The 4-1-1 on IRAs

One of the important details that IRA owners neglect is failing to name beneficiaries for their IRAs. A beneficiary is the person designated to receive what is left in the IRA at the owner's death. Neglecting this detail can dramatically affect the income tax levied on the money distributed from an IRA. If listed as your beneficiary, your spouse has the ability, upon your death, to roll over your IRA into his or her own IRA, then withdraw the IRA funds based upon his or her own IRS-determined life expectancy.

An Important Loophole

As of 2006, to qualify for a Roth IRA, the adjusted gross income (AGI) of unmarried individuals cannot exceed \$110,000, and the adjusted gross income of married taxpayers filing jointly cannot exceed \$160,000. However, unlike the regular Roth IRA, there are no income eligibility limitations to qualify for a Roth 401(k).

By naming children or even grandchildren as beneficiaries of your IRA, you enable them to extend the period over which they can withdraw the inherited IRA amounts over their projected lifetimes, resulting in tremendous tax savings. However, if you fail to maintain an up-to-date beneficiary designation and your IRA passes to your estate, your family must take out the money within five years of your death, resulting in a much greater tax burden.

Doing the 401(k) Math

In a conventional 401(k) retirement account, a worker contributes some of his or her salary into a tax-deferred retirement account. Any money contributed is not subject to income tax when it is put into the account. Employers can offer a Roth 401(k) that allows employees to put all or some of their 401(k) contributions into a Roth 401(k) account. The amount of the worker's salary that is contributed into the Roth 401(k) is considered as taxable wages in the year of contribution, but the money grows tax-free and can be withdrawn later without incurring further income tax. This might be beneficial for younger workers who will not be retiring for a long time, for whom the advantages of a tax-free income in the future outweigh the benefits of deferring present income taxes.

Baby boomers who are looking at ever-increasing federal deficits might wish to opt for the Roth 401(k) as a hedge against what they might think are future income-tax rate increases. And those who still cannot make up their minds can choose to do both: set up a regular 401(k) and a Roth 401(k), and split their contributions. Just remember that the total contributions to 401(k) accounts may not exceed the statutory limits. ●



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Rebecca S. Clement, Publisher; Sarah T. Dayton, Editor In Chief; Joanne Merenda; Art and Design, Robert Smith; Contributing Editor

Retirement Investing

The rule of thumb used to be that you need 70 percent of what you earned before retirement to cover the costs of maintaining the same lifestyle after retirement. That rule has likely become outdated, considering the costs of health care and health-care coverage continue to climb. Some financial advisors believe you will need to generate as much money in retirement as you did working, just to get by. Not very comforting, is it?

The 4 percent solution is something for retirees and potential retirees to consider. This refers to how much money you can withdraw from your portfolio annually and still have enough money to last a lifetime. The number is predicated upon assumptions about the rate of inflation, taxes and return on investments. These are all variables that will not be consistent, but they do provide some sort of historical context for determining how much you can spend in retirement, as well as how much you need to accumulate to finance your retirement.

Keep Working

One incentive for putting off retirement and continuing to work is that the longer you work, the less hard your investments have to work. For many aging baby boomers, continuing to work after typical retirement age might be a matter of necessity — they simply haven't saved enough. Others might want the mental stimulation and socialization provided by continued employment. Another reason is Social Security — a person who has attained the age of full Social Security retirement benefits will still be able to receive full benefits, regardless of how much employment income he or she earns.

Pay Off the Mortgage

In preparation for retirement, should you pay off your mortgage? It depends. Certainly, there are tax-deduction benefits, but if you are older, you might well have been paying on your mortgage for such a long time that the amount of your deduction for the interest is relatively small. In addition, as you near retirement, you are more likely to want to invest conservatively, so the rate of return you will get from conservative investments is probably less than the return you would get from paying off your mortgage. And by paying off your mortgage, you eliminate one more regular bill in retirement and gain a little peace of mind.

Look Into Target Funds

Spreading risk with a balanced portfolio of stocks and

bonds is the best approach to long-term investment. The principle is simple; more difficult is determining the ratio of stocks to bonds and other fixed-income instruments. To a great extent, the ratio is determined by your tolerance for risk.

As you age, though, you might want a more consistent ratio. For example, one formula determines the amount of bonds in your portfolio by multiplying your age by 80 percent, with the remainder of your portfolio held in stocks. In another formula, subtract your age from 100, and use the result as the percentage of assets that should be allocated to stocks, with the rest to be put into bonds and other fixed-income securities.

The one thing these formulas have in common is readjustment — something that some find easy, but others do not. That's why the investment industry created target funds that invest your money based upon when you plan to retire. Your "target" date is the date of your retirement. The further you are from retirement, the more of your fund is held in stocks. Target funds offer convenience and the investment acumen of seasoned money managers. ●

Income Taxes For Seniors

The federal income tax was not designed merely to confiscate our hard-earned money; it was also designed to encourage certain activities, such as charitable giving (which is deductible) and to discourage other activities, such as running up credit-card debt. Buried within the Internal Revenue Code are some tax benefits for older Americans (and their care-giving children) along with some pitfalls to avoid.

Dependents: It All Depends

Just as baby boomers were once claimed as dependents on their parents' income tax returns, many baby boomers are now in a position to claim their parents as dependents on their own returns. A dependency exception is worth money to baby-boomer children who are able to claim one or both parents. For the tax year 2006, the tax exception was worth \$3,300. There are caveats:

- Your parent must be an American citizen or resident alien.
- Your parent may not file a joint income tax return and his/her gross income must have been less than \$3,300 for the tax year.
- You must have paid for more than half of your parent's expenses for the year.

Summary: BOOMER OR BUST

At first look, it might appear that your parent has more than \$3,300 in gross income. If you look more closely, much of their income might come from Social Security benefits — and if those benefits are not taxed, they do not count as gross income. Other nontaxable income is not included in the determination of gross income. Thus, if your parent has gross income of more than \$3,300 from bank accounts or certificates of deposit, you might want to consider moving those investments into tax-free investment options. When figuring whether you can provide more than half of a parent's support, you can count the fair-market rental value of the housing you provide.

You might also be able to deduct your parents' medical bills that you pay on their behalf. You must pay those bills directly to the health-care provider for those costs to qualify for the deduction. Giving money to your parents to pay the bills does not qualify. To take the deduction for a medical expense, you must have paid that bill during the tax year for which you will be deducting it.

You can also deduct nursing-home costs as medical expenses if the primary purpose for your parent or dependent being in the nursing home is for medical care.

Premium payments for qualified long-term care insurance policies may also be deductible as a medical expense.

Head of Household

Unmarried people who support one or both parents can qualify for the filing status of head of household.

You May Be Able to Take the Dependent-Care Credit

Even if you do not qualify to claim your parent as a dependent because your parent has more gross income than is allowed, you still might be able to take the dependent-care credit if you meet the other dependency conditions. To qualify for this credit, you must pay someone to provide care for your parent so that you are able to commit your time to your own employment. If you qualify, you can take a 20 percent credit for up to \$3,000 worth of care expenses; this translates into a tax credit of as much as \$600. And if you are hiring someone to care for both of your parents at a cost of at least \$6,000, you can get a tax credit of \$1,200.

This distinction brings with it less income tax than if one were merely classified as "single." The IRS requires you to pay for more than half your parent's living expenses. You must also be paying for more than half the cost of keeping up the home that is the primary residence for your parent, although this requirement may also be met if you pay half the cost of keeping your parent in elderly housing. ●

Reverse Mortgages

A reverse mortgage is a loan secured by your home, just like a conventional mortgage arrangement. However, with a reverse mortgage, you generally do not have to pay back the loan for as long as you live in the home. This enables you to take the equity out of your home and turn it into cash to meet daily needs without having to be concerned about making a monthly mortgage payment. The loan is repaid with interest, generally when the borrower sells the home, moves out of the home or dies.

With a conventional mortgage loan, you borrow money from a lender and pay it back on a monthly basis. With a reverse mortgage loan, the bank pays you each month and you continue to be able to live in your home.

There are drawbacks. When you have a loan upon which you are not making payments, such as a reverse mortgage, the compound interest grows tremendously. The eventual cost to you is tremendous.

Another catch involves the conditions of the loan. Breaching those conditions is considered defaulting on the reverse mortgage, which makes the entire amount of the loan due.

You must maintain the property in good condition, keep your real estate taxes up to date and keep your home covered by homeowner's insurance. In addition, if you add the name of someone else to the title of your home as co-owner, rent the property to a tenant, take out another mortgage, or use your home for commercial purposes, you will be required to pay back the mortgage at that time.

For Whom are Reverse Mortgages Advisable?

If you are on a fixed income that feels more broken than fixed, and your primary asset is your home (which you do not plan to leave to your children), a reverse mortgage just might be for you.

Reverse mortgages also make sense for “younger-oldersters” who may have serious and chronic medical problems that require continuing care, but who may be able to receive this care in their own home.

Another typical person who chooses a reverse mortgage has a house that has appreciated considerably in value but does not have many liquid assets to support him- or herself or maintain the home.

When you take out a reverse mortgage, remember that you are still responsible for all the maintenance costs, homeowner insurance costs, and real estate taxes. Also, stay away from reverse mortgages with equity appreciation and equity share provisions that will provide higher monthly payments, but can end up costing your heirs more money.

Rarely should a reverse mortgage be the first choice when it comes to obtaining necessary funds for elderly homeowners. However, in some circumstances, it could be the best option available.

Legacy for the Next Generation

If it is important to the elderly homeowner to leave his or her home as a legacy to children, a reverse mortgage might not be the way to go. Instead, the children could help contribute to the parent's financial needs by buying the home, buying long-term care insurance for the elderly parent, or otherwise acting in a manner to meet the elderly parent's needs as well as their own in the long run.

One way adult children can do this is to buy their parents' home and lease it back to them. The parents selling the home get the capital gains exclusion of \$500,000 for married couples and \$250,000 for single people. The children can rent the home to their parents and get deductions for depreciation and other costs of maintaining the property. The children could buy the home from their parents through a lump sum that they can obtain through mortgaging the property themselves, through conventional mortgage sources.

Another way is for the children to purchase a remainder interest in the property, which is the right to buy the property directly and outside of probate upon their parents' death. In this case, the parents keep a “life estate” in the property, which means that they retain the right to live in the property and control the property during their lifetimes. ●

Planning For Long-Term Care

When physical or mental deterioration takes away the independence of baby boomers' parents, families are

faced with a profound choice of either seeking institutionalized care or having care provided at home. Some find an assisted-living facility meets the parent's needs; those who require more care may face the choice of going to a nursing home or receiving in-home care.

Home Care

Home health agency is the commonly used designation for a Medicare-certified agency that is approved to provide Medicare and Medicaid home-health services. Services are usually provided through doctors, nurses, therapists, social workers and homemakers.

Medicare covers the cost of home-health services when the particular services are deemed to be “reasonable and necessary,” when the person needing the services is homebound (unable to leave the home except with assistance), and when the person's physician prescribes the care and periodically reviews the home-health services needs of that person. To qualify for Medicare coverage of home health-care expenses, the patient must provide a certification signed by a physician, indicating that:

- The home-health services are needed because the patient is homebound.
- The patient needs skilled nursing services, physical therapy or speech/language pathology services.
- A plan of care has been established and is periodically reviewed by the physician.
- The services are being furnished while the patient is under a physician's care.

Getting the Facts

If you are going to be a caregiver, you need to know the answers to the following:

- What is the financial situation of the person for whom you will be caring? A detailed financial statement is important.
- What are the person's sources of income and how does he/she access that income?
- What are the expenses involved in caring for the person?
- What kind of insurance coverage does the person have?
- What illnesses does the person suffer from? Get as much specific information as possible from the loved one's physician.

Nursing Homes and Assisted-living

Choosing a nursing home for a parent or grandparent

Summary: BOOMER OR BUST

is a difficult and emotional experience. However, it is a very important task and should be done with much preparation and thought.

When selecting a nursing home, there are a number of key issues to consider:

- **Basic facilities.** How many beds are in the home? How much staff? What is the ratio of staff to residents? Does the center provide the level of care your loved one needs?
- **Fees.** The fee schedule of the nursing home should indicate what services are provided for the regular monthly fee and which services require you to pay extra.
- **Security.** The level of security at the facility is of particular importance if your loved one has a disorder such as Alzheimer's disease, which might result in wandering.
- **Hospitals.** Does the facility have a relationship with any nearby hospitals?
- **Smell.** Too often, the first thing you notice upon entering a nursing home is the smell. If the place does not please your nose, turn around and leave.
- **Location.** Interaction with family and friends is vital to the health and well being of nursing home residents, and interaction is aided considerably when the home's location is in close proximity to those family and friends.
- **Roommates.** Find out how the nursing home determines who will be rooming together and how roommates are changed.
- **Care plans.** Every nursing-home resident has a specialized care plan. Find out how often that plan is reviewed.

Assisted-Living Facilities

There is no precise definition of "assisted-living facility." One unfortunate result of this is a lack of regulation or of vigorous enforcement of regulations where they do

exist. When it comes to choosing an assisted-living facility, the responsibility is yours.

It is generally understood that an assisted-living facility is a facility that provides housing, some level of personal care and some form of health center for people who need assistance with activities of daily life, such as bathing, dressing, eating, mobility and personal hygiene, but do not require the level of services provided in a nursing home.

Although no federal regulations exist for assisted-living facilities, some states maintain state-level regulations, though they often leave much to be desired. Only half of the states, for example, require a nurse to be employed by or contracted with a facility. Just 19 states have any minimum hourly training requirements for care workers. And, although only a nurse can administer medication in a nursing home, 28 states permit assisted-living workers with minimal training to perform that function. ●

Long-Term Care Insurance

Baby boomers can expect to live longer than their parents and grandparents. The bad news is that, for many of us, those latter years may be spent in a nursing home. The worse news is that the cost for the care will likely be extraordinary. A rule of thumb is that people with assets (not including the value of their home) of between \$250,000 and \$1.5 million should consider buying long-term care insurance.

Medical insurance will not cover long-term care needs for people with either a physical or mental condition that renders them unable to care for themselves. Medicare pays for only a maximum of 100 days of long-term care for a nursing home, and Medicaid has serious qualification issues. Long-term care insurance does not automatically cover all three possible long-term care possibilities (assisted living, at-home care and nursing-home care), so it is important to buy a policy that reflects your desires and needs.

Understand Your Policy

Always know exactly what the policy covers, as well as how the insurer handles rate increases. Be aware of any "fine print" or potential misunderstandings that could wind up costing you dearly. You never want to have to decide between paying a tremendously increased premium or letting a policy lapse and wasting years of premium payments.

Information from the Source

When investigating options for a nursing home or assisted-living, one good source of information is the "Nursing Home" section of www.medicare.gov, the official federal government site for Medicare information. An interactive section of the site, "Nursing Home Compare," maintains information on more than 17,000 Medicare- and Medicaid-certified nursing homes throughout the country.

Know the Lingo

The first thing you must do is understand some of the terms, options and provisions found in long-term care insurance policies, among them the following:

- **Length of coverage.** The most common period for long-term care insurance coverage is three to four years. Getting a policy that provides lifetime coverage might not be necessary, but a policy with six years of coverage might be a good call.
- **Waiting period.** This provision delays the paying of benefits for a specific period after you first enter the nursing home. During the waiting period, you are responsible for the cost of your own care. Periods vary by state, but range from no waiting period to a year; most people pick 90 to 100 days.
- **Waiver of premium.** This eliminates the need to continue to pay premiums for a policy while you are in a nursing home and receiving benefit payments from the policy.
- **Nonforfeiture.** This provision allows you to cancel the policy but still receive some amount of reduced benefits if you need long-term care in the future.
- **Renewability.** This is a standard provision that prohibits the insurance company from canceling your policy if you are late paying your premium, as long as you make your premium payment within a specified grace period.
- **Inflation protection.** Things are going to cost more in the future. Inflation protection through a policy provision for a five-percent compound inflation rate will increase the cost of your premium, but it is worth it. ●

Take the Money and Run

When does it make sense to “take the money (your Social Security benefits) and run?” The first thing that comes to mind is that if you need the money and have no other sufficient sources of income, you should take the money early. If your family history is not one of longevity or if you are already in ill health, take the money early.

Conversely, if you are healthy, come from a family blessed with longevity, and can afford it, you might want to put off starting your benefits until you can receive the largest possible benefit amount.

Social Security

One of the great debates over Social Security benefits is when to start collecting. While many, if not most, Social Security recipients wait until their full retirement age of 65, some believe it is best to get that money as early as possible, at age 62, in order to have more control over investing it. In addition, getting Social Security benefits earlier could enable you to leave more of your money to compound in tax-deferred investments for a longer period of time.

Those who postpone applying for Social Security benefits until age 70 will receive a greater monthly payment for the rest of their lives. For each year those born in 1937 and 1938, for example, delay claiming Social Security retirement benefits after they reach full retirement age and until age 70 will receive an increase of Social Security benefits of 6.5 percent. People born in 1943 or later who do the same will get an 8 percent increase.

Fixing Social Security

While Social Security is a flawed system in need of attention, there is no need to “throw the baby out with the bathwater.” Social Security can be fixed, with a few “tweaks.” These include:

- **Tweak 1:** Raise the maximum wages upon which Social Security taxes are levied. In 2006, income over \$94,200 per year is not subject to Social Security tax. Eliminating the cap would affect only 6 percent of American workers, but result in much additional money being paid into the system.
- **Tweak 2:** Invest a portion of the Social Security trust fund in the stock market without any of the monstrous start-up costs and downside risks of individual accounts. Private accounts will not work. Individual investors are in the market for the relatively short run; Uncle Sam is in it for the long run.
- **Tweak 3:** Increase the full retirement age to 70. This would take little tax money to implement and could result in people paying into the system longer and taking money out later.
- **Tweak 4:** A controversial proposal would involve a “means test” for Social Security, so that wealthier individuals would get reduced benefits, depending on their income or assets. ●

Medicare

Medicare is a national system of health insurance for all recipients of Social Security who are at least 65 years old or disabled. Medicare eligibility is not based upon assets or income.

It's like alphabet soup. Medicare Part A provides insurance coverage for hospital care. Part B focuses on coverage of doctor's bills and outpatient services. Part A does not require the recipient to pay premiums. Part B is funded partly through monthly premium payments of Medicare beneficiaries; the federal government pays the rest. Both Part A and Part B require recipients to make co-payments and cover the cost of deductibles for many of the services provided.

Medicare Part C (Medicare Advantage) provides increased benefits for a fee through private health insurance such as health-maintenance organizations (HMOs), preferred-provider organizations (PPOs), and provider-sponsored organizations (PSOs).

Medicare Prescription Drug Coverage

Trying to comprehend the Medicare prescription drug plan (Medicare D) can give you such a headache that you need a prescription drug. The program initially involved more than 80 insurance companies with 10 different companies selling plans on a national basis (there are also a number of plans that are limited by region or state). Overall, in 2006, the first year of the program, there were 3,000 stand-alone prescription drug programs. Many of the plans differ significantly, with deductibles ranging from zero to \$100. Co-payments also vary, as do specific drugs covered.

Choosing a Drug Plan

Consider the following issues when enrolling in a Medicare prescription drug program:

- What is the amount of the premium?
- What is the deductible? Is the total cost of the prescription drugs you take at least equal to the deductible amount plus a year's worth of premium payments?
- Does the plan's formula include the drugs you need, in the correct strength and dosages?
- Are the pharmacies you use in the plan's network?
- Is mail order allowed or required?
- Does the plan require step therapy, by which you must try other drugs before you are allowed to take the one prescribed by your physician?
- Does the plan use tiered cost sharing, requiring different co-payments for generics and brand-name drugs?

- Are there limitations on the number of prescriptions allowed in a month or the number of pills in a prescription?
- Who sponsors the plan? Are they reliable and experienced?
- What are the plan's rules for temporarily providing you with prescription drugs not covered by the plan during a transition period?
- What is the plan's exception and appeals process?
- Do you have coverage through employment so that you do not need to consider a Medicare prescription drug plan? ●

Medicaid

Medicaid is the joint state and federal program that pays for the cost of long-term care in a nursing home. It is the only federal program that pays this cost, and is increasingly turned to for assistance by citizens unable to handle the rising cost of nursing-home care.

Medicaid planning is the name for the legal and financial planning done by lawyers experienced in Medicaid laws. These lawyers help arrange the finances of older clients to make them eligible for Medicaid. An essential element of Medicaid planning often involves transferring assets of older clients to younger family members. Medicaid planning often has a dual purpose — to provide for the nursing home costs incurred and to preserve assets so they can be passed on as a legacy to the next generation.

While there is nothing illegal, immoral or unethical about Medicaid planning, the decision of whether to take advantage of the laws that permit such planning is one that each family must make for itself. It is worth noting that Medicaid planning is an area in which lawyers have found many legal methods that allow clients to avoid some of the more draconian rules and protect a small legacy for their children. ●

Advance-Care Directives

The process of creating an advance-care directive should be ongoing. People's thoughts about their own mortality as well as medical science change over time. The document should reflect your current thoughts, and you should communicate those thoughts to your health-care agent.

The earlier you start to plan for your later years, the more options available to you. People do not plan to fail. All too often, however, they do fail to plan. ●

· Book 16 of 44 ·

Summary



The Reality Behind the Hype and How to Really Profit in the Commodities Market

Commodities Rising

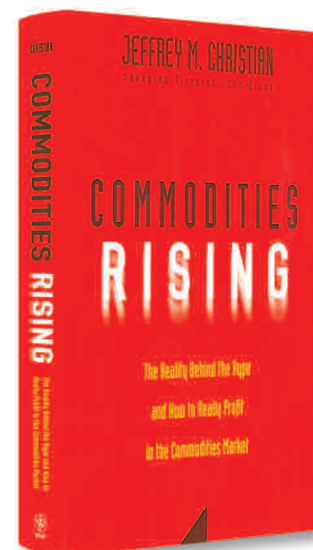
THE SUMMARY IN BRIEF

Commodities are the building blocks of the world economy and financial markets. They are the wheat that travels from the fields of Kansas to the bakers of North Africa. They are the timber from far eastern Russia that travels to furniture makers in North Carolina. They are the oil pumped from the Middle East that is refined and put into your gas tank. Commodities, as Jeffrey M. Christian succinctly puts it, are “stuff” — stuff we use every day, stuff we might not even think about as investments, but which are nevertheless traded around the globe, accounting for billions in venture dollars spent here and abroad.

It is in and around this trading that Christian, managing director of the CPM Group (a New York-based consulting firm specializing in commodities research), sees a great deal of money changing hands, as well as a great deal of misinformation being spread. In *Commodities Rising*, he explains in detail how commodities markets work and shares his strategies for long- and short-term investment. He tells how to best incorporate commodities into a well-balanced portfolio. He also addresses and debunks the many myths that circulate about the market and its major players. And along with his current portrait of this volatile yet profitable market, he offers a glimpse of what the future might hold.

IN THIS SUMMARY, YOU WILL LEARN:

- Why now is a good time to invest in commodities.
- The specific pitfalls to avoid in commodities investing.
- How commodities can be used to reduce risk and increase returns.
- How to separate good commodities information from bad.
- Why commodities are profit-generators.
- Details about specific commodities, such as gold, silver, petroleum, corn and others.
- The many ways to invest in commodities, including physicals, equities, forwards and options.



By Jeffrey M. Christian

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THE COMPLETE SUMMARY: COMMODITIES RISING

By Jeffrey M. Christian

The author: Jeffrey M. Christian, is the largest shareholder and managing director of CPM Group, a New York-based consulting firm specializing in commodities research.

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The Commodities Rush Is On

Commodities are things. They are stuff. They are the building blocks of the real economy. They are called tangible assets in the financial markets, along with real estate and art. These markets are often seen as more interesting than equity and bond markets because they are tangible, a trait that attracts a certain kind of investor.

Commodities prices have risen sharply since 2003, a fact attributed to an increased use of basic commodities in China and other developing countries, as well as increases in actual demand within both developing countries and industrialized nations (including the United States and Japan) alike. Still, the majority of investors who get involved in futures contracts to buy or sell commodities at a specific price at some point in the future lose money, in large part because they approach these markets with many misconceptions about commodities and fail to do their homework both before and while they are involved in the futures markets.

There is, however, a great deal of money to be made in the commodities market — from gold and oil to wheat and coffee — by investors and traders who do their homework and avoid getting caught up in the market hype; who, in other words, keep a level head about expectations and perform the due diligence required to succeed. In commodities markets, as well as in the broader economy, the investors who do the best over the next few years will be those who are as willing to sell markets short, betting prices will fall, as they are to go long, betting prices will rise. Shorting, of course, takes a special psychological composition — one that is unafraid to sell in the face of market optimism.

Why Commodities? Why Now?

In the past few years, commodities have captured much of the center stage in international financial markets. There are three major reasons for the current rush into commodities:

- **The risk is deemed worth it.** World economic, financial and political trends and conditions have turned hostile since 2000; consequently, stocks and bonds have not done so well during the period between then and now. Investors have taken on greater risks in the search for investment returns, and one of those risks has been to move into commodities.

- **Their maturity as investments.** Commodities were traditionally disparaged by financial markets, which saw them as too volatile and complex to analyze. Today, commodities have gained new respectability and desirability as assets, comparable to stocks or bonds. They can compete in terms of capital appreciation potential, generate profits themselves and are useful as elements of a diversified portfolio.

- **The usual rise and fall.** Commodities prices have been rising, and investors chase rising prices. In any other segment of the economy, rising prices lead to lower demand, and vice versa. Investment demand, however, is positively correlated to prices: Investors buy more of investments as prices rise, and less as prices fall.

Avoiding the Pitfalls

A great deal of money will be made by investors and others in commodities over the next few years — and a great deal of money will be lost by other investors in commodities over the same period of time. Those who make money will be more nimble investors who buy and sell commodities based on reasoned and rational analysis of supply, demand and economic trends.



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Rebecca S. Clement, Publisher; Sarah T. Dayton, Editor In Chief; Chris Lauer, Senior Editor; Christine Wright, Senior Graphic Designer

The commodities markets are often misunderstood, even by many of the largest and most central participants. It's not unusual to find mining executives, for example, who do not understand even the basics of how their metal is traded internationally. Some think that, in order to get gold prices to rise, the sale of gold jewelry must rise; in truth, the demand for gold investment must rise in order for the price of gold to lift. This kind of lack of basic knowledge is not unusual (and not unique to the gold market). There are numerous reasons for the prevalence of bad information in the commodities markets, including:

- **Lack of Regulation.** Commodities markets are largely unregulated and overrun by incredibly bad information often passed off on the market by seemingly legitimate groups that simply do not know what they're talking about. This is known as fabricating statistics.
- **Faulty Statistics and the Asymmetrical Market.** The quality and accuracy of available statistics on commodities is dreadful. Commodities markets are asymmetrical, which means information is not readily available or uniformly available across the market, so some people know a lot more than others. The commodities markets are inefficient because they are ill reported, relatively small, populated by relatively fewer numbers of market participants and relatively illiquid.
- **Marketing Hype.** Much of the rhetoric that investors are hearing today about why they should be loading up on commodities has been around for decades. Much of it is just wrong. ●

The Myths Of The Commodities Supercycle

Many investors and others, who have marginal expertise in the commodities markets, have come forth with a wealth of profound, albeit inaccurate, advice as to how to profit from a coming "supercycle" in commodities prices. The degree of misinformation contained in some of the messages being circulated by these new gurus is astounding and appalling — unfortunately, such statements often go unchallenged and are accepted as truth. The idea that informs all the hype about supercycles is that commodities prices have begun rising sharply over the past two or three years and now are embarking on a long-term upward trend toward historically high levels.

Much of the rhetoric that is stirring up investor interest in commodities is strongly reminiscent of the "new economic paradigm" jingoism that surrounded the late

stages of the bull market in equities in the late 1990s. At that time, equity market commentators spoke of a new economic reality that precluded recessions and that would be characterized by eternally rising equity values. That house of cards, of course, collapsed spectacularly.

There are several major problems to this thesis. First, it flies in the face of economic realities — higher prices tend to stimulate increases in supply and to decrease the use of a good or service. There also has been a major increase in exploration, development and expansion in a wide range of commodities, which is likely to increase supplies over time. These economic mechanisms tend to serve as a brake on rising prices.

What Has Actually Changed in Commodities Markets?

The current upward movement in commodities prices is a natural reaction to an extended period of time in which commodities prices were depressed. For some commodities, it has further to go; for others, there are signs it is already overdone. In addition, there have been some major changes on the demand side of most commodities markets that have inspired a rise in commodities prices. The key changes include:

- **Deregulation.** There has been a move in India, China and other countries toward deregulated markets, allowing for a more rapid expansion in industrial output and final demand and the emergence of domestic consumer classes to buy goods and services. This has increased total demand overall for many commodities.
- **Investment.** There has been an upward shift of the investment demand curve, as investors — including many institutional fund managers who have never touched commodities — have moved into investing in commodities.
- **Supply Curve.** While fabrication and investment demand have shifted to higher levels, the long period of under-investment in production has caused the supply of many commodities to lag.

The Myth of the Chinese Consumer Giant

Economic development has boosted overall activity in China. It has also stimulated tremendous growth in demand for basic commodities as raw materials for China's industry for goods manufactured both for export and for domestic consumption. China has become an economic powerhouse. Part of the current hoopla about commodities among investors relates to the concept that Chinese demand for a wide range of goods will lead to an unrelenting and irreversible

growth in demand for these goods. Although there is some truth to this, there is much more sizzle than there is steak in this story.

Let's separate facts from the hype. While there is an urban consumer class emerging in many parts of China, there are not 1.3 billion people suddenly rushing out to buy cars, washing machines and other items that require copper, steel, gold, platinum and other materials. There is tremendous income disparity within China, and the gulf between the haves and have-nots is widening. Most Chinese households cannot afford cars, or washing machines or many of the consumer goods common in the West.

Chinese production is also a factor in why the hype is unlikely to pan out. The commodities bulls focus on China's textile growth and its need for cotton, conveniently overlooking the rapid increase in China's cotton growing in recent years. The bulls look at China's increased copper and aluminum consumption, overlooking the fact that the country's domestic productive capacity is rising even further and faster, to the point that China is shifting from a net importer to a net exporter of such materials.

Yes, China is emerging as a major market for many commodities, but enthusiasm must be tempered about what this means for markets. In many markets, from steel to silver, China is increasing not only its domestic raw material requirements but also its own domestic productive capacity. ●

Commodities And The Global Economy

Many market observers have used commodities, both in general and individually, as indicators of overall economic conditions, as a leading indicator of inflation or as barometers of overall economic activity and health. This may not be wise, as the conventional wisdom of a relationship between commodity prices and overall economic conditions does not hold up to quantitative analysis.

Commodity prices also historically have been much more volatile than general price inflation. While inflation at times has moved broadly in line with commodity prices, statistical evidence suggests that the relationship is not a very tight one.

People tend to look at commodity prices as indicators of future inflation for several reasons. For one, a long time ago, commodity prices were more important to the

general economy, and there is a traditional view that commodity prices are indicative of broader economic trends. Another reason is that many commodities are traded on public futures exchanges, which allows price increases to show up more quickly and more prominently than in other sectors of the economy.

Commodities and Economic Output

Clearly, there is a relationship between demand for commodities and overall economic activity levels. As real economic activity expands, people and companies are using more commodities. As disposable incomes rise, people buy more things, most of which are made out of some commodity. Thus, demand for commodities tends to rise and fall in line with real economic activity.

The relationship is very complex, however, and it is not a one-for-one move. Technological changes increase and decrease the need for individual commodities, both in individual products and industries and in relationship to broader economic activity. As intensity of demand fluctuates, changes in economic activity have a greater or lesser effect on commodity demand and prices. There is no simple formula or pattern that explains or predicts the relationship between commodity prices and real economic activity. Not only is there no clear statistical relationship, but the lags and leads between the two shift dramatically from time to time.

Commodities and Economic Development

It may surprise people who view the world economy today as a post-industrial, information-based economy, but basic commodities remain a vitally important part of economic development and international trade. Basic industries and basic commodities are often overlooked in efforts to foster economic development; this is unfortunate. It is clear that if a country has natural resources that can be developed and used, it is better off in the long run if it develops the resources it has. Unfortunately, many executives and economists involved in international development belittle the concept of natural resource development.

Information and Knowledge

Information is critical to commodity markets, as it is to all markets and commerce. Knowledge — understanding what to make of all that information — is even more critical. Both accurate information and substantive knowledge are in relatively short supply in the commodities markets. Management scientists talk about organizational systems that learn, meaning corporations,

industries and markets that effectively develop and manage a set of collective information and knowledge. The commodities markets are learning slowly and haltingly and have not been efficient in this regard in recent decades.

The commodities markets are strewn with terribly expensive, destructive mistakes rooted in a lack of information, lack of knowledge, lack of understanding and lack of analysis. The coffee market, for example, has been destroyed for many years to come by massive over-investment in poor-quality plantations that have glutted the markets. Similar patterns occur repeatedly in other markets.

These conditions exist in large part because basic commodities industries and markets have been victims of neglect and under-investment for years. It also reflects misguided government policies and academic theories that significantly underestimate the importance of basic commodities, even in advanced industrial economies. The fact that most governments, international governmental agencies, nongovernmental organizations and corporations ignore commodities means that the collective will, wisdom and investment necessary to implement effective reform is not present in these industries.

Improving Conditions

There are efforts under way to improve the use of information and knowledge in commodities markets worldwide. One set of projects is represented by the collective efforts of the World Bank, the United Nations Conference on Trade and Development (UNCTAD), the European Union, the Common Fund for Commodities and other international organizations, to try to develop a bridge between developing countries' commodities producers and processors, on one hand, and the international commodity finance markets on the other.

The European Union started the program in 1997 by seeking a replacement for commodity price support programs that were costly and ineffectual. This led to the creation of the International Task Force on Commodity Risk Management, managed by the World Bank and joined by numerous other organizations. Educational services, training and information dissemination are needed to assist commodity producers in learning how to use hedging tools effectively. An honest broker and facilitator can help commodity producers learn to use what instruments are available. ●

Commodities As An Asset Class

Commodities have become an asset class, in the words of the marketing departments on Wall Street. Many institutional fund managers have moved into commodities, in many cases for the first time ever. Another new development has been the release of some academic and market research quantitatively discussing the validity and usefulness of commodities as investment vehicles.

Commodities traditionally have been seen as something less than full-fledged investment-grade assets by many mainstream financial market types. That is one reason why larger investment banks, brokerage houses and others call them, even today, *alternative* assets, which are, for many reasons, becoming more acceptable in polite financial circles.

Commodities have at least two very important roles to play in investment portfolios:

- They can generate profits in and of themselves, through capital appreciation. Studies have shown what ample empirical evidence has well illustrated, that great wealth can be generated by investing in commodities.
- Commodities perform very well as part of a diversified portfolio of investments. Commodities generally have a very low statistical correlation to other investment assets such as stocks and bonds. This does not mean that they move in the opposite direction from stocks and bonds. It means that over time they move randomly relative to these other assets. Sometimes they all rise together, sometimes they all fall together and sometimes they move in opposite directions. This is what you want in a portfolio diversifier.

Commodities on Their Own

For long stretches of the 1980s and 1990s, many commodities did not make sense as investments, unless you were either facile at short-term trading or willing to go short the commodities. Platinum did pretty well, but gold fared terribly, particularly in the 1990s. One of the problems with traditional comparative return studies is that they tend to compare individual commodities to baskets of 500 stocks. That is not fair, nevertheless, it is commonly done.

The real key comes when you take a long-term view. Comparisons of the returns and risks of various commodities and commodities indexes to stocks, bonds, bills and stock market indexes over the long run show that commodities stand up very well in comparison. Stocks, generally speaking, did poorly in the 1970s, but soared in the 1980s and 1990s. They have not fared as

Summary: **COMMODITIES RISING**

well since 1999. Commodities did well in the 1970s, partly because stocks did so poorly and partly because the prices of many important commodities, from gold and silver to oil and gas, were heavily regulated, controlled, fixed or managed by governments. As those practices ended, commodities prices played catch-up with inflation. If you include the 1970s and the current decade so far, commodities start looking more attractive compared to stocks.

Over the long run, commodities can make sense as stand-alone investments. One has to be careful to invest wisely, but commodities can clearly compete head-to-head with stocks and other more traditional investment assets. ●

Commodity Investment Vehicles

There are a number of ways to purchase commodities, both directly investing in commodities and indirectly buying exposure to commodities process through the stocks of commodities-producing companies, special investment vehicles and commodities-oriented investment funds. One can purchase physical commodities, futures contracts and forward contracts, as well as options and other investment vehicles. Common approaches include the following:

Physicals

The purest and most straightforward approach to commodities investment is, of course, to purchase the commodity outright. This is often done with gold, silver, platinum — the precious metals that also serve as financial assets. It is relatively easy to store precious metals, since they have a high value relative to their volume. They are also relatively more available in physical form for investors than are many other commodities.

It's also possible to purchase physical metals used in some of the more esoteric markets, such as rhodium, iridium, ruthenium, bismuth and cobalt. Buying these metals may be relatively difficult but doable, but selling them at some future time, when the market has either risen in your favor or fallen at your expense, could prove difficult, even impossible. It takes a special breed of investors to be willing and able to understand and take on the sorts of risks inherent to such investment vehicles.

Futures

Most investors focus on exchange-traded futures as the way to invest in commodities. While physical purchases do not make sense, many investors prefer the leveraged

exposure to commodities prices that futures offer.

A futures contract is an agreement to later buy or sell a commodity in a standardized amount, quality grade, and so on, under the terms and conditions of an organized futures exchange. U.S. futures exchanges trade standardized contracts. They have a clearinghouse established to assure creditworthiness of all registered market participants. The trades occur through the clearinghouse and not on a principal-to-principal basis. Futures are offered on a wide range of commodities, though not on some of the more esoteric commodities.

Forwards

A forward contract is basically similar to a futures contract, except that forwards are not traded on any organized futures exchange. Forwards are principal-to-principal (between two parties) contracts, usually with a dealer or bank on one side and an investor, user or producer on the other. Forward transactions can be customized to meet a specific client need in terms of delivery points, grade, volume, type of material and so on. A forward contract is a cash market transaction. Producers and others can sell on a forward basis, while consumers and others can buy on a forward basis.

Options

Options are contracts that give buyers the right, but not the obligation, to buy or sell a commodity. Options are sold both on organized exchanges and over the counter by dealers and banks. A lot of market nomenclature surrounds options. It is no wonder that investors getting involved in exchange-traded options must sign a paper that says they understand options.

There are three broad categories of options. The buyer of a call option has the right to buy, or call for, a commodity. The buyer of a put option has the right to sell that commodity or put it on the market. The third category is compound options, which consist of combinations of puts and calls. The potential combinations (and their revenue impacts) are endless.

Exchange Traded Funds

These are relatively new investment vehicles for commodities. Exchange traded funds have exploded in the equities market where they consist of baskets of stocks that investors can buy into. In the early part of this decade, some gold market people decided to create a gold ETF that would invest solely in physical gold held in allocated accounts and would be designed to track physical gold prices as closely as possible. The

concept was based on the reality that many investors, including institutional investment fund companies, did not invest in gold bullion because it was too unusual, or cumbersome, compared to their typical equity and bond investments. The gold ETFs appear to have been initial successes, attracting larger institutional investment firms that did not invest in gold previously.

Equities

Investors often use the equities of producing companies to build exposure to commodities prices. This works for oil and gas companies, coal companies and mining companies. It is not a pure way to invest in commodities, however, as there are a number of complications. Investing in a commodities-producing company involves taking risks related to the company's management, the quality of its properties and deposits, country risk in the places where it operates, geological risk and more. Beyond mining and energy products, the ability to invest in commodities through the equities of producers is much more limited.

Mutual Funds

Sector-specific mutual funds are available, but they tend to be too rigidly managed, often due to restrictive charters. They tend to be long-only, not allowed to short these markets when prices seem too high or likely to fall. They also are often limited to investing in equities and equity options.

Commodity Funds

Most commodity funds spend most of their time and attention on financial futures. Most are also technically oriented funds, trading based on price charts, momentum indicators and so-called "black box" computerized trading strategies they have devised. These might not appeal to you if you like fundamentals and macroeconomic factors.

Hedge Funds

Most hedge funds — and there are thousands of them — do many things and, generally speaking, commodities represent a small portion of their portfolio. The best hedge funds have total discretion as to which assets and markets they invest in, and they are allowed to be both long and short. ●

Precious Metals

There are dozens of commodities in which one can invest. One has to invest the time to understand the mar-

kets, however. Otherwise sober investors often seem to throw logic, wisdom and their best analytical processes to the wind when it comes to investing in commodities. Investors who follow extremely rigorous and disciplined fundamental methodologies for investing in stocks seem to believe that when it comes to commodities, there are easy earnings to be had. They read an incredible report from an unknown person on the Internet and throw money at the wildest concepts in commodities. If they were to read a similar report about a stock, they would run for the hills.

Below are discussions of several precious-metal commodities.

Gold

Gold is the granddaddy of all commodities. It has been the single most intensely pursued commodity in the history of mankind, the stuff that dreams are made of. As a commodity, gold is used primarily in jewelry, but also in a host of industrial applications, from electronic components to coating for reflectors used in industrial ovens to bake paint onto metal.

Gold is a relatively small part of the overall physical commodities market, but the largest part of the commodities investment pool. This means that there are a lot more ways to invest in gold than there are in other commodities and a lot greater liquidity in gold investments than in comparable commodities-oriented investment sectors. Gold is purchased in the forms of gold bullion coins, numismatic coins, bars, ingots and other bullion forms. It is also purchased in futures, options, over-the-counter forwards and other derivatives. Many investors never purchase gold, per se, but invest in gold mining equities or mutual funds that specialize in gold, precious metals or natural resources.

Silver

Silver, like gold, is both a commodity and a financial asset, though it behaves more like the latter than it does the former. A tremendous amount of silver trades every day, far in excess of what one would expect based on the fundamentals of supply and demand. As a result, its price is extremely volatile. Some see silver as a "high-octane" gold, in that silver's price tends to outpace gold in percentage terms. Silver prices rise when supply and demand would send the price of a more typical commodity lower, and fall when market observers think it ought to be rising. Whatever you think you know about silver, you do not know enough to accurately call this metal's price patterns on a consistent basis, over the long run.

Like gold, silver is a major investment product. There are physical silver investment products (100- and 1,000-ounce bars), as well as medallions and coins minted by refiners and the U.S. and Canadian national mints. Silver futures and options are traded on the New York Comex, the Tokyo Commodities Exchange and the Chicago Board of Trade (CBOT). Silver equities are also a common way for investors to buy exposure to silver prices. ●

Energy Commodities

Energy commodities include petroleum, natural gas and uranium. Uranium is not traded on a futures exchange, but it has been of particular interest to investors lately and is likely to continue to be interesting.

Petroleum

Petroleum prices have risen sharply recently, and the commodity's price outlook was probably less ascertainable than ever before as of late 2005 and early 2006. Predictions as to future prices from respectable sources ranged from \$25 to \$100, and that is excluding the fringe crazies. Overall, however, prices are expected to remain strong. That doesn't mean they will continue to rise at the pace seen since 2003, nor does it mean prices will rise to \$100 and stay there. It means that prices could rise to \$100 in a spike and fall back to a new base of \$35, \$40 or maybe even higher.

One point to make clear is that economics still apply. Everyone who can is drilling for oil and they will find it. This, coupled with a modest slowing in the rate of demand will help prices come lower.

The world is consuming around 84 million barrels per day at present. Supply and demand are rather closely matched. World oil consumption has been rising at an accelerating pace over the past two decades. Add to this equation the fact that China was producing about 3.5 million barrels a day in 2005, but consuming up to 6.9 million barrels a day, making the nation a critical focus as a source of rising demand.

Investors can invest in petroleum through a number of vehicles. Oil is traded primarily on the New York Mercantile Exchange (Nymex) and the International Petroleum Exchange (IPE). There are numerous oil- and gas-producing companies, and an even greater number of exploration and development companies. There are petroleum trusts, a range of equity vehicles and energy-oriented mutual funds. ●

Grains And Oilseeds

Corn, soybeans and wheat are among the largest agricultural commodities markets in the world. The fact that these crops, like cotton, are newly planted every year means that farmers have flexibility in responding to changes in demand and price.

Corn

Corn is the single largest grain crop in the world. It is grown around the world, but the United States is the largest producer and consumer by a wide margin. Corn prices have spent most of the period since the early 1970s trading between \$2.00 and \$3.00 per bushel. Recent prices have fluctuated; prices spiked to around \$4.86 in 1996 but fell to \$2.00 in late 2005. Prices recovered to around \$2.10 to \$2.20 in early 2006. At this time, many corn market participants expected corn prices to drop into a range of \$1.60 to \$2.20, reflecting higher output, lower U.S. exports and high market inventories.

Corn futures and options are traded on the CBOT. This is the largest corn futures market, and the focal point for most U.S. investors and traders. Corn is also traded on the Bolsa de Mercadorias y Futuros in Brazil. Smaller futures markets exist in Budapest, France, Korea, Japan and Argentina. ●

The Fundamentals Still Apply

The fundamentals still matter in determining commodity price levels and trends. Nonetheless, many analysts and other market participants do not fully understand what the fundamentals are in each commodity market. Also, the measurement of these fundamentals is much poorer than most analysts and observers realize. Lastly, the relationships of various fundamentals, exogenous variables and price movements are complex and do not lend themselves to simple explanations and analyses.

The future of commodities as investments is neither boom nor bust. But investors need to do their homework. Commodities lend themselves to honest analysis, and such honest work can be rewarded with handsome returns. ●

· Book 17 of 44 ·

Summary



Financial Bliss

A Couple's Guide to Merging Money Styles and Building a Rich Life Together

THE SUMMARY IN BRIEF

As a financial planner and advisor, Bambi Holzer helps couples grapple with complicated financial issues, but often the real issue to deal with is a personal one lurking just below the surface of the couple's financial considerations. One partner is risk averse, for example, while the other wants to strike it rich. One partner might not want to give up their current lifestyle to chase the other's goal. Another couple might be identical financially, leading to blind spots and missed opportunities. Holzer's goal is for these couples to become aware of their differences and how they can work through them to make their financial life more successful.

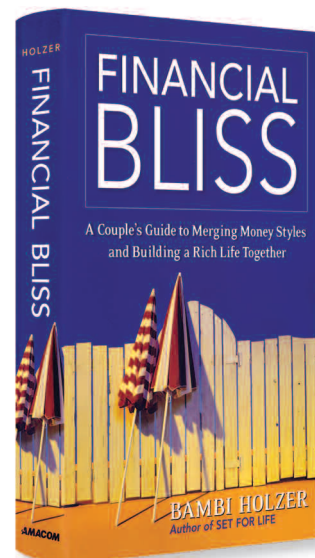
The premise is simple. If you can understand yourself and your relationship with money, understand your partner and his or her relationship with money, and understand the implications and facets of the many financial decisions you will face as a couple, then you will have planned safely for your financial future and the future of your relationship.

Specifically, this summary will show you how to marry your partner's tolerance for financial risk with your own, and to match your compromises with your individual and shared aspirations at critical life stages.

Holzer introduces her ideas with the following formula: Knowledge is Power. Power is Control. Control is Security. Security is Bliss. You utilize this knowledge and power through communication with your partner, with your experiences and with experts. Once you have power, you can control your environment. The control that knowledge-power provides lessens risk and makes you feel secure. Being free of worry about your finances is "financial bliss."

IN THIS SUMMARY, YOU WILL LEARN:

- How to have a better financial relationship with your partner.
- How to identify your own "money" personality and style.
- How to organize your financial life as a couple.
- How to prepare for and work through your financial life events.
- What you need to do to successfully invest now.



by Bambi Holzer

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THE COMPLETE SUMMARY: FINANCIAL BLISS

By Bambi Holzer

The author: Bambi Holzer, owner and president of Bambi Holzer Financial Group, provides investment advice to individuals and families, and is the author of *Retire Rich* and *Set for Life*.

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Love ... And Dead Ends ... Are Blind

Financial matters are highly charged with emotion, so it should come as little surprise that many couples are incapable of resolving their financial differences.

Because couplehood involves two human beings, it takes good communication skills for these unions to thrive and to survive. As the emotional charge rises, our ability to communicate effectively falls.

Is it any wonder that financial conflicts are responsible for a high number of divorces?

A burgeoning field of study called *behavioral finance* tries to track and make sense of the decisions we make with our minds and our money. For example, economists and stock-market theoreticians have long wondered why the efficient market theory doesn't seem to hold all the time in real life.

What these researchers found seems pretty obvious once brought to light, but has complicated economic forecasting by adding elements of psychology and probability that had not been previously factored into its calculus of the economic order of the world. For individuals, it means that we now have names for some of the economic decision-making maladies we carry around in our brains. Now that we can identify them, we can try to compensate for them. And that's the point — when you identify the tendencies and characteristics of your own economic decision-making, you can avoid the pitfalls, turn your weaknesses into strengths, and understand for yourself and explain to your partner why you made a particular financial decision.

Here's the good news: Just because you haven't been able to communicate effectively about finances, doesn't mean you can't. It simply means you haven't. "Haven't" implies yet. Your yet is today.

Making Assumptions

Which is the more likely cause of death in the United States — being killed by falling airplane parts or being killed by a shark?

Because the media sensationalizes fatal shark attacks, most people select shark attack as the more likely cause of death. The truth is that for approximately every one person killed by a shark, 30 people will die as a result of falling airplane parts. When given a choice we tend to select the familiar.

Making Assumptions About Ourselves

Where behavioral finance crosses the line from minutia to matter is when it helps us to understand how we perceive ourselves generally. It's important that you know upfront that you are biased. Like the vast majority of people, you will rate yourself more highly than an objective third party would. Repeat: It's important to recognize that you have this bias.

Are You Sure?

It is interesting to note that behavioral economists have discovered that as our self-expressed certainty goes up, the likelihood of our being right goes down. In other words, the more certain we are about something, the greater the chance that we will be wrong. When people are 99 percent sure of themselves, they are right about 70 percent of the time. What's important to note is the discrepancy between what we believe about ourselves, our abilities, and our answers and reality.



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Primacy, Recency and Frequency

Have you ever noticed that once you buy a certain car you see more and more of them on the street? Our consciousness becomes alert to things that have been already brought to our attention. In decision-making, we tend to be swayed by the viewpoint that gets the most hits. Supporting the old contention that even bad publicity is good publicity, we do create a bias for those things that are on the top of our mind.

We all overestimate our knowledge; as a result, our overconfidence can lead us to make mistakes. Because we think we know it all (or a large percentage of it all), we don't do enough research or we employ rules of thumb as shortcuts.

In addition, we often think that our individual experiences are representative of the wide possibilities actually obtainable. We trust our intuition or the intuition of experts without actually tracking how well that intuition has done in the past. It is important to realize that you don't have a corner on the market of financial acumen.

Finance is in the Eye of the Beholder

It is important to be honest with ourselves and our partners about our relationship with money — what tools and information we use to make money decisions. Without such self-knowledge and sharing, there will always be money fights and self-inflicted money problems.

Your money style consists of how and why you spend money, how you make decisions about it and what it means to you. You need to recognize your style and identify what your partner's style is in order to make better decisions together. Once you realize how each of you operates, you can work better as a team.

What do You Like About Money?

What does money mean to you — love, safety, happiness, power, freedom, self-worth? Why do you feel that way? How were your beliefs and values about money formed?

Separately, you and your partner should probe your values, goals and views on money. Digging a little under the surface might bring up thoughts or feelings that end up being very important both to you and your relationship. After some reflection, schedule time to talk about your thoughts.

- What are some of the “money messages” you live by?
- Where did they come from?

- Have you reexamined them lately to see if they still are, or ever were, valid?

The Financial First Date

Words carry an emotional weight, and just as it's important to think about your own money style, it is equally important to think about your own communication style. The point of a “financial first date” is to share information and stories so that you get a fresh portrait of what each person in the couplehood brings to the union. Then go for the good night kiss and ask for the next date.

Let the Negotiating Begin

After facts and feelings have been expressed, it's time to negotiate. Write down the mutually acceptable agreement you've arrived at so that you both ensure that you have understood each other. This is not a method to hold someone to a perceived contract but a way to ensure that you both understand what was said.

When you finish, share positive comments with each other, and celebrate a successful move forward in your partnership. ●

Conducting Your Financial State Of The Union Meeting

Before you hold your first State of the Union Meeting, you need to complete two tasks: Determine your net worth and track expenses for one month.

With your net worth and budget homework done, you can begin to assess where you have been, where you are now and to decide where you want to go next.

First, it's a good idea to look at your budget results. Remember, the point is not to make drastic across-the-board cuts or blame yourself or your partner. Instead do some soul-searching and some negotiating with your partner to figure out what can be cut, and where it should go. Look for places to downsize that have the least impact on your lifestyle.

Next it is time to set goals. This is a time for taking specific, manageable, daily, weekly and monthly steps toward a tangible, attainable goal like reducing credit card debt to zero in two years. To make certain that your goals aren't pie-in-the-sky platitudes, you have to:

- Be specific.
- Be realistic.
- Think action-oriented.
- Account for dual accountability.

Summary: FINANCIAL BLISS

- Have consequences and rewards for meeting/not meeting deadlines.
- Prioritize wisely. ●

Yours, Mine And Ours

Sharing is hard. It is a difficult concept to teach our children, and remains a difficult concept for us as adults.

Whether you choose, or are able to enter into, a legally recognized union or engage in some other type of merging of lives and finances, you need to address some fundamental questions.

Whether married or not, one of the biggest stumbling blocks is assets coming into the relationship that are unequal or if income is unequal. That's a pretty common experience. So regardless of the income divide that separates you, you have decisions to make:

- Do you split living expenses 50-50 or do you split them relative to income?
- How much say does one partner have over how the other spends their money?
- Who makes the investment decisions?
- Do you pool your money or keep separate accounts?
- Does one of you become the bookkeeper/accountant? ●

No Secrets: Keeping And Maintaining Good Financial Records

Managing your financial information and sharing it with your partner will ensure that your partner can run things if you should become disabled. This will also ensure that at your death, the estate will remain intact and be handled in the way you want. Unlike the decrees that affect a marriage, there is no default decree for unmarried couples. You need to delineate how your agreement with your partner was handled and should be handled at your death or disability. If you have previous unmarried partners, documents from those relationships should be included.

Keep your documents in a safe, secure place. But make sure that more than one person knows where to find the complete set of information. ●

Setting Up House

The pace of life is so great these days that even the milestones of buying a home to having children to

retiring and more can sneak up on you. More important, the costs associated with these life events have risen to such heights that the play-it-by-ear attitude now means that you could take it in the ear and suffer harsh consequences.

The Contractual Basis of Marriage

Financial matters are a relatively straightforward part of marriage because married persons enter into a contract with well-established legal ramifications. Unmarried couples aren't governed by these rules. Living together, in and of itself, does not create a contractual relationship. It does not entitle either party to a property settlement should you split up or one of you dies. As a result, all assets that were bought together, as well as commingled assets, are divided based on established contract law rather than on informal understandings. It is important for unmarried couples to write down contracts to clarify their wishes regarding property rights and to take actions to keep property rights consistent with the contracts.

Ever wonder why the prenuptial agreement became a necessity? It's because of the law's clarity with regard to property and marital assets. If you and your partner want to enter into an agreement that is not standard issue, the prenup is the way to go.

It should be noted that answers to legal and financial issues require experts who can examine all the aspects of your relationship and your unique needs as you form your version of couplehood.

Pitfalls to Watch for

Insurance and bad credit are two potential problems to be handled carefully. If one of you has bad credit, creating contracts or taking actions, which move property into that partner's ownership or even cosigning for that partner gives creditors the ability to attach that property to cover debts owed them. It might be better to leave assets out of creditors' reach by maintaining existing ownership. Moving assets out of the account of the debtor partner won't usually work, as creditors can go after assets transferred within a certain period prior to default.

A partner with no insurance also poses issues. Just as creditors can seize assets, judgments in civil cases can reach the property of the defendant. A car accident by an uninsured partner can put assets in the other's name at risk.

The experts at the Alternatives to Marriage Project suggest unmarried couples should at the very least create the following agreements:

- Durable power of attorney for health care
- Durable power of attorney for financial management
- Will — By legal default, without a will only relatives have access to your assets
- A living-together (or domestic partnership) agreement that spells out the financial aspects of your relationship.

Knowledge is Power

Because so many laws and statutes vary from state to state with regard to marriage and other domestic arrangements, it behooves you to know before you enter into any kind of arrangement to learn as much as you can about the nature of the agreement — whether implied or stated — in the area in which you live.

Buying a Home

For most of us, buying a home is the American Dream, and the largest single outlay of cash in our lifetime. Today, given low interest rates, a proliferation of lenders, lower qualifying standards for loans, low- or no-down-payment loans and other market forces, purchasing a home is easier than ever.

The toughest hoop most couples have to leap through is the down payment. Ten-percent-down payment loans are becoming more common, but the tried-and-true 20 percent remains the gold standard, and could earn you a lower interest rate. Cash gifts from parents, friends, etc., are always possible, but lenders expect full disclosure, and can examine your financials to determine your suitability.

If you are unmarried, and you are mingling assets for a down payment, be especially careful of gifts. The IRS may view the money received by one partner as a gift to the other. For tax purposes, there are limits before a gift tax kicks in. In addition, make sure that if ownership interests are different from the ownership interests shown in the deed that you create a contract that specifies the terms.

How do we Finance It?

A few basics here illustrate the different instruments that exist to finance your purchase:

- **Fixed 30** — Best if you are staying awhile, rates are low and you prefer the security of an unchanging payment.
- **Fixed 15** — Same as Fixed 30, but paid off more quickly, and usually at a lower rate.

How Much Can We Afford?

Five to 10 times your combined annual income is the ballpark price-range to keep in mind when determining how much you can reasonably afford to pay for a home.

And as you are saving for that first home, live for a few months with the projected new mortgage cost as part of your budget to see how it feels.

- **ARM** — Great if rates are projected to fall and you don't plan to stay more than about seven years.
- **No Down** — Makes sense for those with good earning power but little money to contribute right now. Some risk of negative equity if home prices decline.

Forms of Ownership

How you legally own your home has lasting and consequential impact on your finances and legal obligations. Getting things settled beforehand makes things much simpler. Talk with your lawyer and financial planner first to ensure that how you own the property fits your situation:

- **You or your partner could own the property alone.** The other is merely a tenant or guest with no ownership rights. The non-owner partner is in a risky situation because the owning partner has complete control over the home.

- **You could own the property together.** Any two or more people can own property together. You don't need to be married or even a couple. Or you can be "tenants in common" and spell out ownership interests.

- **If you are married, you might be more likely to own the property in joint tenancy.** Joint tenancy means that you share equal ownership of the property and have equal right to its use. If one of you dies, the other automatically receives the deceased's share of the property.

In the interest of being prepared, it is a good idea to have a plan in place for the dissolution of your couplehood. A simple buyout contract that you and your partner draw up, spelling out the terms of this agreement (whether you are married or not) is a good idea.

Children and Couplehood

For purposes of this discussion, the term "family" is used to describe any household in which two adults reside with at least one minor.

Summary: FINANCIAL BLISS

Courts don't care why people have children. If a child arrives, both biological parents (married or not) have a duty to support that child. That said, it is crucially important for a father to acknowledge paternity. If he's not certain that he's the father, he should register that uncertainty as well.

Laws vary from state to state regarding adopting your new spouse or partner's children, but those laws, and the process of adoption are usually pretty straightforward. Remember, both biological parents must agree to adoption unless one has abandoned or failed to establish a parent-child relationship.

Paying for Education

Given the skyrocketing cost of higher education, Uncle Sam has come up with some generous programs to help us pay for college.

- Qualified Tuition Programs, also named "Section 529" plans, allow you to either prepay a specified beneficiary's future education expenses or to establish a savings plan that will pay those expenses in the future. Anyone can establish one for the student — it is not limited to parents. Given how quickly college tuition rates rise, this is an attractive option.
- Coverdell education savings accounts, sometimes called Education IRAs, are another savings instrument with tax benefits. Coverdell's aren't limited to use for college; they can be used for elementary and secondary school, too. ●

Being Prepared For Emergencies

Sometimes life proves that we don't have absolute control over our destiny. Our only alternative is to plan ahead and develop some protection against things we can't control.

For unmarried couples, the situation can be a little more complex. Without the legal bonds of marriage, your commitment to each other is reliant on whatever domestic partnership agreement you've created, and your individual ethical beliefs.

Create a Rainy-Day Account

One of the most important steps you can take to prevent an emergency from becoming a catastrophe is creating a fund to cover living expenses in case of an interruption in your income or some catastrophic loss. Some advisers think a six-month cushion is sufficient.

You need to use an investment that is extremely liquid and extremely safe such as:

- Treasury bills
- Short-term government bonds
- Money-market mutual funds
- Bonds
- Bank savings accounts or Certificates of Deposit.

Insurance

Insurance should be a cornerstone of your rainy-day protection. Depending on your stage of life and financial health, insurance in its various forms can be helpful in getting you through some of the events that put a burden on your finances, but it could also be an expensive proposition. A study by the Insurance Research Council reports that couples spend about 16 percent of their annual incomes on insurance.

Your best bet is to consult with a certified public accountant. An expert can cut through the interference, and speed the process of evaluating your insurance needs. ●

Retirement

Married couples may have informal, unspoken contracts with each other, and unmarried couples may have established formal contracts about how to manage certain aspects of their relationships. With retirement, many of those contracts won't work anymore.

What Will the Assets You Already Own be Worth When You Retire?

Go back to your net-worth worksheet and, as a conservative estimate, use liquid assets, savings and investments less any assets you cannot sell as your funds to retire on.

What rate of return should you use to calculate the rate of appreciation? This is tricky, since we are trying, in a sense, to predict the future. As always, past returns are no guarantee of future performance. As a general estimate however, past performance gives some indication of the long-term returns. By starting with the asset's rate of return, and reducing it by the amount it will be taxed, you will have an estimate of what will finally end up in your pocket.

Unfortunately, inflation reduces the value of your savings and needs to be factored into your calculations. By subtracting inflation upfront in your calculations, you'll have a better estimate of the amount of money

you'll need in the future. Use today's amounts to estimate an overall inflation rate over the period you're examining.

How long will your money last? That depends on two things – how much you spend each year and how long you live.

How Much Will You Need to Spend Each Year?

For many people, living expenses really don't decrease during retirement. And don't assume that your taxes will go down after you retire. Depending on how well you saved, your income may not decline that much. And deductions may go down if you pay off your mortgage, reduced some of the dependent and employment-related deductions that you relied on in the past.

How Long Can You Live on Your Accumulated Assets?

Some experts have looked at long-run returns, the outlook for the stock market, the cost of living, and increasing life spans, and have pronounced that spending 4 to 5 percent of your nest egg each year of your retirement is the correct number. Individual circumstances, especially health and your local cost of living, certainly affect that result. ●

Estate Planning

The basic steps in planning your estate are to determine:

- Who you want to have your assets — the beneficiaries
- What assets you have or will likely have
- Strategies to get those assets into the right hands and minimize the amount that the IRS gets.

Another piece of good advice for those going through the initial planning stage is to talk about it with the people involved. Involve your partner in your thoughts. Feel out your prospective beneficiaries to determine whether your ideas about their needs and wants match up with your wishes.

After You

If you think you will be the first to die, it's not a good idea to merely leave everything to your spouse, then let her figure out what to do with everything in her will. That's not estate planning.

If you are unmarried, it is even more vital to have estate-governing methods in place. State law does not include an unmarried partner as a default beneficiary of the estate.

Executor

Anyone can be the executor, and you should choose someone you trust. Some people choose an unbiased professional, such as an estate lawyer, bank trust officer or accountant. Choose wisely. Here are some suggestions:

- Don't choose someone your own age.
- Only choose a professional you know well and who is very clear about your wishes.
- Beneficiaries may not be good executors if you have complicated financial issues or family issues.
- Name more than one executor.

How Estates are Calculated

To determine your estate-tax burden, you should start by calculating your gross estate — everything you own minus everything you owe. Assets that you don't own at the time of your death are not part of your estate, so they are not taxable. The more you get rid of before you die, the less tax your estate will have to pay.

Ownership of the property is an important consideration in determining your taxable estate. If it is solely in your name it is part of the estate. If you hold something jointly, only your portion of the asset is considered part of your estate.

Hidden Assets

Be aware of hidden assets that need to be included. Life insurance proceeds are only includable if you've made your estate the beneficiary. Retirement benefits that are paid upon your death are generally included in your estate.

What is Probate?

Probate is a court procedure that makes sure your assets go where you want them to go after you're gone. During probate, the court will determine whether the will is valid. The court will then oversee the distribution of assets and final settlement of the estate. Probate involves filing an inventory of the deceased's assets and liabilities as well as the actual will, and these filings are open for public inspection. No wonder people try to avoid probate if at all possible.

How Property Passes to Heirs

You can pass property to your heirs through:

- Gift
- Contract
- Operation of law
- Will

- Trust instrument
- Your state's laws of succession.

Popular Estate-Planning Strategies

If you want to avoid probate, if your estate is large enough that you will be facing tax consequences or if you want to put some controls on the distributions of your assets after you die, you will likely enter the world of trusts.

• **Credit-Shelter Trust for Married Couples with Over \$2M in Assets.** The credit-shelter trust is to fully use both spouses' unified credits — hence the name. It is set up so that when the first spouse dies, the amount that qualifies for the estate-tax credit goes into a trust instead of going directly to the surviving spouse. The trust owns the assets, but the surviving spouse receives income from the trust.

• **Living Trust to Avoid Probate** — It allows you to do the same basic job as a will while avoiding the probate process. However, unlike other trust vehicles, a living trust does not affect your estate-tax situation.

• **Testamentary Trust** — Controlling your estate from the grave. Testamentary trusts allow you to be more specific about who should get your assets — and when. Testamentary trusts don't exist until you die.

• **Charitable Remainder Trusts** — For giving and receiving. This trust allows you to donate assets to a non-profit organization, receive the tax breaks from the donation and still receive the income from the assets while you are alive. ●

What To Invest in Now

Which stock should you buy? A fundamental analysis of stocks will give you a list of what to invest in. The fundamentals to look for are:

- Do they operate in a good market with successful products?
- Are they well-managed?
- Do they have some protective competitive advantage?
- Do they have the financial wherewithal to operate successfully?
- Are they fundamentally sound?

You can rely on others for this analysis — brokerage houses and banks, Internet sources and independent research firms like Value Line and Morningstar provide such analysis. If you want to do it yourself, you can col-

lect the information from 10-Ks, the Internet, news services and other providers.

Fundamental analysis will give you a list of what to invest in. But just as importantly, you have to decide when to invest in the promising companies you've uncovered. Even the best stocks go through periods of over- and under-estimation of their prospects. Industries and sectors go through cycles of popularity and neglect. Rather than lament the inefficiency, randomness, and craziness of the market, use it to improve your returns. Many methods exist to time your investment purchases and sales more efficiently.

One method is to use point and figure technical analysis because it boils the supply and demand and emotional aspects of the market down to an understandable and time-tested charting system. You can use it to find entry points as well as to know when to sell.

You should find a method that fits your temperament, available time and abilities. Many great online and written resources are out there to explain each of the methods. Investors should read *The Wall Street Journal*, *Money* magazine, *Smart Money* and *Kiplinger's Personal Finance*. Online resources include Yahoo! Finance, Morningstar, Inc., TheStreet.com, and Bankrate.com.

Mutual Funds as Your Investment Vehicle

Consider mutual funds as the best method for investing in nearly every category of investment assets. They provide professional investment management and are easy to find and invest in. As situations change, moving from one fund to another within the same family is easy and nearly always free.

There are now more mutual funds than actual stocks on the major exchanges. It can get complicated deciding which funds to buy unless you're organized about it and have specific criteria. Services such as Morningstar exist to rate the return and risk performance of funds.

The size of your portfolio and your income also bear upon how much risk you should take. The more money you have invested relative to your needs, both current funds and those set aside for retirement, the more risk you can take on.

Your task now is to find your financial bliss. As you begin, keep in mind the principles of good communication and honest negotiating. With more information at your fingertips, these conversations are less likely to be chats and more likely to be work sessions in which you can make important and informed decisions. ●

· Book 18 of 44 ·

Summary



How to Identify and Invest in the Hot Stocks of Tomorrow

Finding The Next Starbucks

THE SUMMARY IN BRIEF

If you are looking to invest in tomorrow's winners, it's unlikely you will find them by reading Wall Street research. Wall Street is focused on reporting on companies everybody already knows about.

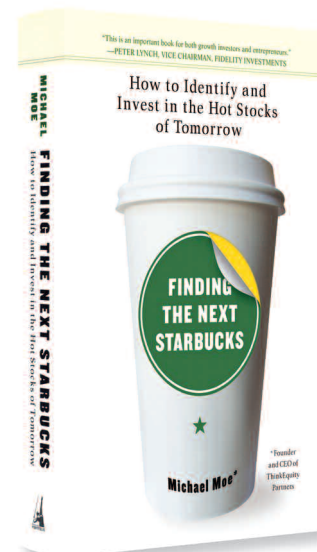
Author Michael Moe, awarded "Best on the Street" among U.S. analysts by *The Wall Street Journal*, explains how winners like Dell, eBay and Home Depot could have been spotted in their start-up phase and provides methods to use to find Wall Street's future giants.

Part of the secret to investing success is to make complex things simple and use a systematic framework to achieve your objectives. Moe explains the characteristics he looks for in small companies that have the potential to become big companies, including his formula for identifying and evaluating companies, valuation methodologies and his use of the four Ps to identify future superstars: great people, leading product, huge potential and predictability.

Using his framework to identify the stars of tomorrow, he identifies key investment areas that investors should look at today to find tomorrow's huge winners, including peer-to-peer networking, nanotechnology and alternative energy. Wall Street insiders and individual investors alike will find his insights and methodologies an indispensable guide to spotting growth opportunities.

IN THIS SUMMARY, YOU WILL LEARN:

- How to find the "Supernovas."
- Why high earnings per share equals a high internal rate of return.
- The "10 Commandments" formula for identifying and evaluating the stars of tomorrow.
- Eight megatrends considered to be key waves of the future.
- The value of people, product, potential and predictability — the four Ps.



By Michael Moe

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THE COMPLETE SUMMARY: FINDING THE NEXT STARBUCKS

By Michael Moe

The author: Michael Moe, Chairman and CEO of ThinkEquity Partners LLC, was formerly director of global growth stock research at Merrill Lynch. He has been named to Institutional Investor's All American Research team and has been awarded "Best on the Street" by The Wall Street Journal. Quoted regularly by national publications, he is a frequent guest on CNBC and CNN.

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Finding The Supernovas

The story goes that when infamous thief Willie Sutton was asked why he robbed banks, he replied, "That's where the money is." Similarly, the reason for focusing on growth companies is because that is where the greatest potential investment returns are. In the short term, a variety of factors influence stock prices — geopolitical events, interest rates, oil prices, etc., but in the long term, one thing influences stock prices — earnings growth! Over time there is nearly a 100 percent correlation between a company's earnings growth and its stock performance.

The reason why Google, Starbucks and Dell have had spectacular stock performance is that they have had spectacular earnings growth. Unfortunately, in growth investing, often what seems like the next Starbucks turns out to be the next Boston Chicken. It is important to have a process to identify the stars of tomorrow and avoid the Roman candles.

Obviously, faster is better, but the minimum growth rate for admission is also a function of a company's size. The smaller a company is, the faster it needs to be growing to be of interest.

Growth and Risk

One of the golden truths of high finance is the relationship between risk and reward: the greater the potential reward, the higher the perception of potential risk. Ultimately, in sports, gambling, investing and life, there is little value in knowing what happened yesterday. The largest rewards come from anticipating what will occur in the future.

Fundamental in the pursuit of investment opportunities is the philosophy of risk and reward. Risk should be viewed as measuring the potential for permanent capital loss, not short-term quotational loss, and assessing the probability of that against what we think the value of a business will be in the future. The goal is to find a stock whose price is below the appraised value, not what the quotational value is as indicated by the current stock price. The stock should also be in the "right neighborhood" of industries where there is tremendous market growth potential. Admittedly, stocks having these qualities are not easy to find, but are worth the pursuit.

The Growth Opportunity

In searching for the fastest-growing companies with the greatest potential, the best pond to be fishing in is the small-cap pond. An investor who can identify a young, unknown company with a lot of growth potential will benefit not only from the long-term earnings potential, but also from the herd nature of investors as the opportunity becomes more widely recognized. ●

The Power Of Growth — The Magic Of Compound Interest

Understanding the magic of compound interest and the power of earnings is critical to appreciating why growth investing has such huge potential rewards. Compound interest, high earnings growth rates and time create a potent combination that leads to spectacular returns. Even slight differences in short-term returns can produce dramatic results over a meaningful time period when aided by compounding.



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Math of Negative Returns — The Other Side of the Sword

Sadly, negative returns drastically undermine the magic of compounding. The cold, hard fact of investing in growth stocks is that volatility is the norm and living with short-term negative returns is part of the game. The way to win long-term is to focus on fundamentals with earnings growth and price performance running in tandem over time, and when wrong, to be intellectually honest and admit it. ●

High Earnings Per Share = High Internal Rate Of Return

It would be convenient if, to pick tomorrow's winners, you just had to look at past results. Unfortunately, that plan doesn't work.

For example, of the 100 largest-capitalization companies in 1925 in the United States, 23 were in the railroad industry. Fast-forward to the year 2005, and no railroad companies were among the 100 largest companies.

While you won't find the winners of tomorrow by reviewing the winners of the past, it's instructive to analyze the top-performing companies to learn what to look for in identifying the stars of tomorrow.

After considering the profiles of the top-performing companies, it is apparent that long-term stock performance is principally determined by earnings growth, not initial valuation, while the prevailing valuation is the result of proven operating success. The conclusion is that investors seeking to identify top-performing companies in the future should not focus on bargain stocks or even "momentum" ideas, but rather identify growth companies that compete in large addressable markets and possess dynamic long-term growth potential.

In addition, companies that operate in industries propelled by tailwinds will generally outperform the market. A tailwind occurs when a company and/or industry benefits from the trends that are shaping society. But those companies that are capable of successfully capitalizing on growing markets, rather than simply relying on the favorable tailwind, will capture larger market shares, be rewarded with premium valuations and ultimately deliver the greatest shareholder value.

A key principle for successfully investing in emerging-growth companies is to be very disciplined about limiting the number of companies you invest in. Knowing intimately what you own allows you to avoid some of

the big blowups, and stick with companies even if they are hitting some bumps in the road.

Three Rules of Growth Investing: Earnings, Earnings, Earnings

A study of top-performing stocks indicates that the long-term performance of a stock is nearly 100 percent correlated with a company's earnings. As rapid earnings growth dictates long-term performance of a company's share price, it is important to focus on identifying the most rapidly growing and dynamic markets and, naturally, the companies participating in the growth of those markets, or better yet, driving it.

Smaller companies are typically pure-play investments, with their products and services strategically focused on a particular market's growth. Large, established companies, on the other hand, are typically burdened with more mature businesses and frequently operate in less related markets than those that smaller companies are focused on.

In one respect, small companies have a competitive advantage with their ability to develop a market niche ahead of others, while their size and focus position them to remain nimble as the market continuously develops.

In another respect, lack of size can be a competitive liability if a market niche remains underdeveloped or not well defined. This reality leads many small companies to realize sub-par profit margins and more often to fall behind the industry growth rate — the quintessential "me too" company.

Ultimately, to achieve rapid and sustained growth in earnings, a growth company must participate in a dynamic market such as the information technology, healthcare, or alternative energy industries. The most successful of these growth companies are the ones that develop their own market niche and introduce proprietary products and services, with minimal competition, allowing them to achieve sustained above-average industry profitability and ultimately create tremendous shareholder value.

High EPS Growth + Beating Expectations = Megawinners

Nirvana for a growth stock investor is the combination of high earnings growth and beating expectations — the likely result is the "double play" of consistently high earnings growth and an expanding P/E multiple.

The stars of tomorrow generally are microcap in size, have a relatively high P/E and have high earnings growth over a sustained period. ●

Formula For Identifying And Evaluating The Stars Of Tomorrow

One of the most bizarre realities of Wall Street is the generally random process security analysts use to evaluate investment opportunities. Basically the “process” for doing security analysis is to hire bright, ambitious people and tell them to do their thing. Sometimes it works. And often it doesn’t. If Starbucks hired kids off the street and told them, “Go make a latte,” very few people would have ever heard of Starbucks.

If you want to be a great investor, you need to be systematic and strategic in how you analyze companies. The following are “10 Commandments” through which investors can create the foundation to enhance their investment returns:

1. Be right on the fundamentals. Earnings growth drives stock price. Focus on the fastest-growing companies.
2. Be proactive. Looking ahead and anticipating where the world is heading is how to catch winners early on.
3. Be rigorous, but don’t have rigor mortis. It is possible to over-analyze opportunities. The best investments are often easy and intuitive.
4. When wrong, admit it. The best investors are wrong a lot, do not rationalize a mistake.
5. The cockroach theory. If you find a problem at a growth company, there are always more behind it.
6. Investment ideas are about information and insight. Insight is valuable if we know what that information means.
7. The four Ps (people, product, potential, and predictability) are key for any successful growth company.
8. Use five independent sources for each stock you invest in.
9. Find three main reasons for a stock to move up or down. Maintaining a thesis for why you own a stock is key.
10. Be passionate about investing but dispassionate about the investment. ●

Megatrends

Megatrends are defined as powerful technological, economic and social forces that develop from a groundswell, move into the mainstream, and disrupt the status quo, driving change, productivity, and ultimately growth opportunities for companies, industries, and entire economies.

Eight megatrends are considered to be the key waves of opportunity. Those companies best able to recognize and harness the growth opportunities made available by these megatrends will be those that first capitalize on, then extend their lead over the competition.

These eight megatrends and future trends are likely to be extensions of past megatrends, though the pace of change will be more accelerated, with rapid capitalizing on cumulative advancements in technology, demographic shifts, changing consumer preferences and improved business efficiencies.

Megatrend 1: The Knowledge Economy.

Today’s economy is a knowledge economy based on brainpower, ideas and entrepreneurship. Technology is the driver of today’s growth economy, and human capital is its fuel. Fundamental to success in the new economy is how companies obtain, train and retain knowledge workers.

Megatrend 2: Globalization. Capital and customers are scouring the globe 24 hours a day, seven days a week for the best return on investment for products and services. Globalization accentuates the need for a company to have a claim to fame and accelerates the exposure of mediocre business models.

Clusters (defined as geographic pockets of companies tied together by a common industry, though not necessarily companies within the same industry) enable firms within the cluster to be more specialized, benefiting the growth and competitiveness of the entire cluster.

China and the Internet are the two major forces that will shape the world for the next 50 years. Key trends include the growing middle class, urbanization, and growth in inter-Asian trade. These will all result in greater demand for products and services such as television, computers, automobiles and travel.

Like China, India has a lot of people and a rapidly growing middle class that will fuel consumerism. India’s IT outsourcing and business process offshoring are, combined, a \$300 billion industry growing at 25 percent. Looking for and evaluating the stars of tomorrow, trolling the Indian waters for opportunities will be crucial, and understanding the “Indian” strategy of a domestic company will be too.

Megatrend 3: The Internet. The world population adopted the Internet more quickly than any other new technology in the history of the world. It took commercial aircraft 54 years before 25 percent of the population used it. It took electricity 46 years. VCRs took 32 years.

Summary: FINDING THE NEXT STARBUCKS

Cell phones took 16 years. Only seven years after the commercialization of the Internet, 25 percent of the world's population had used it.

The Internet is not an industry but a megatrend that impacts all industries. While there are pure Internet businesses, the Internet as an agent for change impacts everything from government to automobile manufacturers to music companies. It is necessary to analyze how the Internet will create opportunity and also change business models.

By asking how the Internet impacts the business opportunities for an emerging star, or how it influences a more traditional industry, you will be in a better position to catch the largest waves of opportunity.

Megatrend 4: Demographics. Understanding demographics gives investors a very predictable window to the future. Demographic trends over the next 20 years will prove incredibly dynamic. In short, emerging demographic shifts not only will play a primary role, but also, given the size and scope of the changes taking place, will prove disruptive to past technological, economic and social legacies. Wise investors will find huge opportunities emerging where these legacies are falling away.

Dynamic demographic trends will play a primary role in health care, travel and leisure, minority marketing, women-centric services, wealth management and spiritual products.

Megatrend 5: Convergence. In the game of football, great quarterbacks do two things that separate them from average quarterbacks. First, they see the whole field and don't get trapped by focusing narrowly on one receiver or zone. Second, they are able to see two or three moves ahead.

Investors need to be able to do both. Convergence is the term used to describe the coming together of two or more distinct entities or phenomena. Much of the emerging area of nanotechnology is around the converging fields of computer storage, semiconductors, biotechnology, manufacturing and energy.

Underlying the drive toward convergence is the goal of wider collaboration and the increased recognition that linked knowledge is of far greater value than disconnected knowledge.

Megatrend 6: Consolidation. Consolidation occurs when a business grows through buying other businesses in its industry. The classic recipe for a consolidation is where there is a wildly fragmented industry dominated by mom-and-pop businesses. As an industry starts to consolidate, the consolidator benefits from scale and

service advantages that make it increasingly difficult to compete against.

Megatrend 7: Brands. A brand is a promise between the company and the consumer about what to expect from the relationship. It takes years to build brand goodwill, but once it's achieved, it gives the company permission to introduce other products and services consistent with that promise. A strong and visible brand is a key ingredient in the formula for strong products.

Megatrend 8: Outsourcing. To compete and to win, leading companies need to determine what their core competencies are and outsource basically everything else.

The general rule is that the more knowledge-intensive a business or industry becomes, whether due to technological, production, or global marketplace complexities, the greater the number of functions that will need to be outsourced to sustain competitive advantage. The ability of a company to innovate and meet customers' changing needs is progressively more dependent upon how effectively it manages organizational change around its most strategic assets. ●

The Four Ps

After looking for industries driven by key megatrends and finding opportunities within these industries that have potential for a high and sustainable earnings growth rate, use the four Ps — people, product, potential and predictability — to differentiate the stars of tomorrow from the ordinary companies. Finding stars that exhibit the four Ps isn't simple, but doing so is the key to long-term investment success.

People — Follow the Leader

The biggest part of the secret to success in investing in tomorrow's big market winners is evaluating the people running the company. There is no shortage of interesting ideas, but it's always the people that make the difference. The goal is to find a great leader at the head of a great team.

Nobody ever wants to invest in average people, but how can you tell? Unfortunately, it's not simple.

There are a number of questions a potential investor must ask in order to properly evaluate a company's people, such as:

- What is their prior work experience, and reputation within the industry?
- What have management and employee turnover been, and what is their track record for developing and promoting talent?

Summary: FINDING THE NEXT STARBUCKS

- Is there a passion to build a significant lasting company or to build it up and flip it? (How much stock does management own?)
- Do they do what they say they are going to do — are they honest?
- Is there a proper balance between short-term expectations and building long-term value? Do they under-promise and over-deliver?
- Are they building a culture where everybody shares a vision and believes they're on a mission? (Are they ego-centric or team-focused?)
- Are they systematic and strategic in building their business — do they degrade their competition?

Over time, evaluating how management executes against its promises and opportunities is the key to finding the megawinners.

Product — What's the Claim to Fame?

Attractive companies need something that makes them special or great — they need a claim to fame. Starbucks is the preeminent provider of gourmet coffee, for example.

For a company to be a leader, it needs to be expanding its market share profitably. Generally, this means that a company should be gaining share among its competitors without decreasing margins. Starbucks has been raising what it charges for a cup of coffee for 15 years amidst increased competition but hasn't missed a beat. Coffee prices have fluctuated greatly, but Starbucks' margins have steadily increased.

There are exceptions to this — call it the Wal-Mart doctrine. Wal-Mart became the largest retailer in the world by charging its customers less so it would make more. For years, Wal-Mart made less in gross margins but actually did make it up in volume so that operating margin remained stable while market share soared.

While it's exceptionally difficult to find truly world-class management teams, it's just as difficult to find companies that have a truly great product. The only way to find them is to do a lot of digging.

With companies that provide a service, there are generally three metrics that star companies have:

- Revenue per employee — a critical metric for comparing a company to others in the industry
- Recurring revenue from existing customers — a company with a high proportion of its revenue as recurring almost always sells at higher multiples to its growth rate

- Non-forced employee turnover — for companies in general, but service companies in particular, low non-forced turnover is a good thing.

Potential — How Big Could This Become?

In order to have gigantic winners, you also need huge potential. Where the growth sectors intersect the megatrends is where the stars of tomorrow will be found. This intersection is the best place to focus research and resources.

The classic investment opportunity is where there is a problem — the bigger the problem, the bigger the opportunity. The education market is an obvious place where there are big problems and big opportunities. Online education wasn't a market 10 years ago and now it's a \$6.3 billion market and growing.

Within megatrends there are minitrends that develop. Minitrends might be huge in terms of opportunity but narrow as they relate to impacting all the growth sectors. Examples of minitrends (and their corresponding megatrend) are: one-stop shopping (consolidation), wellness (demographics), woman power (demographics), Internet learning (knowledge economy and Internet), and travel (globalization).

Having a framework for determining where the world is heading guided by megatrends and minitrends, it is equally important to understand where the world is not going. Negatrends are secular shifts in society, the market, and/or politics that will result in shrinking market opportunities. Mom-and-pop shops are a negatrend as shown by the disappearance of the corner drugstore or local hardware store.

Predictability — How Visible is the Growth?

One of the biggest challenges for a young, fast-growing company is delivering operating results that are predictable. Investors reward management teams that under-promise and over-deliver and they punish companies that habitually miss expectations.

But predictability is a relative term. Some industries and business models are much more predictable than others. The key to determining a company's predictability and its ability to perform against expectations is partially business model, but also partially a function of the first three Ps: people, product and potential.

Recurring revenues are the Holy Grail of predictable, visible growth. Recurring-revenue businesses almost always have big premiums to their multiples because of their visibility.

Summary: FINDING THE NEXT STARBUCKS

It's critical that an investor creates a predictability framework that's appropriate for a specific industry. For example, there are terrific earnings growth opportunities in the biotech sector where a company won't have revenues for a number of years. But because of the people, the product and the potential, it could be a compelling investment.

In pre-revenue companies, the first three Ps take precedence, but key milestones a company can perform against give investors evidence that it's on track to capture the opportunity. ●

Valuation Methodology

Having a valuation methodology can provide rigor to analyzing a company's potential. A disciplined framework for valuing companies will reduce the risk of chasing a stock that is way ahead of itself without fundamentals to support it.

Whether a company is a high-octane biotech company or a pedestrian farming-equipment manufacturer, the way to determine its intrinsic value is the same — by calculating all its future earnings and discounting those earnings back to today. So, rather than seeing how much money you will have next year, you look at money expected in the future and see how much less it is currently worth. Thus, next year's \$1 is worth only about 95 cents today, which could be invested at 5 percent to produce about \$1 a year from now.

While “discounted cash flow” is the academically correct way to determine what a company is worth, it's only as good as the inputs based on future guesstimates. The mistake you often see the MBAs making is they actually believe the guesstimates are real.

Two other valuation methodologies allow a growth investor to triangulate to get a good perspective on the current and correct value of an emerging growth company.

- P/E to growth (P/E/G) is the classic way growth investors have valued growth companies. Divide a company's 12-month forward projected price/earnings ratio by the company's 3–5-year projected growth rate. The rule of thumb is a normal growth company selling in a normal market environment should trade at a P/E/G of 1 or 100 percent. The problem is of course, defining normal.

- Price to sales (P/S) is a great valuation tool to triangulate the discounted cash flow method and P/E to

growth valuation technique. To calculate a P/S multiple (share price X shares outstanding = market cap, or P in the equation) versus the company's revenue growth rate and its longer-term EBITDA (earnings before interest, taxes, depreciation, and amortization) margins. The higher the revenue growth and the higher the EBITDA margins, the higher the appropriate P/S. A “normal” company, with an average revenue growth rate and average margins, should sell at a P/S multiple of approximately 1.0x. Normal for this purpose is considered to be 10 percent revenue growth and 10 percent long-term EBITDA margins.

Long-term earnings growth is what determines stock performance, but in the short term, many factors influence share price, including inflation, interest rates, market valuations, investor sentiment, inflows (outflows) into equity funds and IPO activity. ●

Sources And Resources — Finding Ideas

To locate great ideas on where tomorrow's stars will be, you need a systematic and strategic process, just like you do to analyze these ideas once you find them. The Internet is the world's most efficient research tool, and Google is the engine that drives it. The blogosphere is without question the place where the best dialogue on tomorrow's winners will take place. The hard part is to sort through the noise and engage in smart conversation.

Reading newspapers and magazines, listening to industry experts, knowing what smart public and private investors are doing, and asking the right questions when doing your homework are all part of the idea toolbox.

The government puts out some great information as well. The U.S. Department of Labor provides data on where the market job growth is, what cities are booming, hot careers and good general economic indicators. The U.S. Department of Energy gives great info on alternative energy and initiatives in energy technology. The U.S. Bureau of the Census provides information on everything you could want to know about the U.S. population and demographic trends. The Centers for Disease Control and Prevention (CDC) has tremendous information for health, medical and safety issues. ●

Think Tomorrow, Today — Hot Areas For Future Growth

There are investment areas that investors should look at today to find tomorrow's huge winners. Undoubtedly, the shelf life for some of these areas will be short, but that is the nature of growth investing. Creating forward-looking scenarios is a critical step in spotting future winners.

The bridge to a new medium almost always starts by taking the old processes and transferring them to the new medium. Accordingly, the first phase of the Internet, Web 1.0, was dominated by businesses that tried to put everything and anything on this exciting new medium.

Web 2.0 is a term coined to imply that after the dot.com crash, the Web became even more significant. The principle behind Web 2.0 is that the Internet has emerged as the global platform for communications, commerce, information, services and product development.

Creating a network effect and leveraging the collective intelligence of the World Wide Web is at the core of many of today's most powerful business opportunities. These include:

Online advertising. The new code of advertising will be driven by analytics, metrics, and a one-on-one marketing approach.

Open source. With the advent of the Internet as a collaboration tool came open-source software. It returns control to the customer. The code is open and transparent. Open-source models succeed by monetizing a license relationship with the open-source community. Examples include Apache, Linux and Wikipedia.

On demand. Many of our core needs are already being served in an on-demand fashion. We sign up and expect to immediately get connected for phone, cable, for gas and electric and for security services. The on-demand migration is just beginning in the world of software.

Just-for-me media. Podcasting, blogs, and video blogs are examples of Web-based technology that allow customers to find and participate in their area of interest.

Cell phones. Increasingly, the cell phone is replacing the computer as a means to get information, entertain and communicate. Societies like China and India have leapfrogged to the future, and have started with the cell phone being the phone, computer, game system and more.

Biotech and health care. An important investment theme will be smaller biotech companies that have a single potential blockbuster product being acquired by the blue-chip growth companies or traditional pharma companies.

Digital doctor. Hand-held record keeping and patient-information systems, records that can provide better information for care, and other products to provide superior health-care and lower cost will be part of an explosion of products and services for the digital doctor.

Education in the knowledge economy. With broadband delivery able to give students access to classrooms and curricula around the world, technology can lower the cost, improve the access, and in some cases even improve the quality of a college education.

The power of women. Women's issues will be getting more CEO attention, legislative funding and societal support. Having more women in the workplace increases the need to outsource services traditionally provided by stay-at-home moms.

Premium brands. Consumers are ready, willing and able to buy products and services they believe are without peers.

Minority to majority. The growing population of Latinos will be the growth driver for many of the consumer trends in the United States from restaurants, to clothes, to music and entertainment to financial services. Targeted media such as Univision and focused marketers have a huge tailwind for the next 50 years.

Safe and secure. With the government becoming a major driving force and client, 9/11 has spawned new business around "physical" security. Opportunities will involve new applications such as VoIP, Web services and storage networks. In a mobile world, wireless security grows more important.

Alternative energy. The International Energy Agency (IEA) forecasts that over \$1 trillion will be invested in non-hydro renewable technologies worldwide by 2030. By then, the IEA predicts, such technologies will triple their share of the world's power generation to 6 percent.

Nanotechnology. Nanotechnology is tiny technology that fundamentally changes the rules of science. Through nanotechnology, convergence of distinct disciplines of chemistry, biology and physics can create applications and solutions previously unimaginable. By 2010, nanotechnology will significantly influence information and communication technology, health care, consumer markets and energy technology. ●

· Book 19 of 44 ·

Summary



Achieve All Your Financial Goals Faster Than You Ever Thought Possible

Getting Rich Your Own Way

THE SUMMARY IN BRIEF

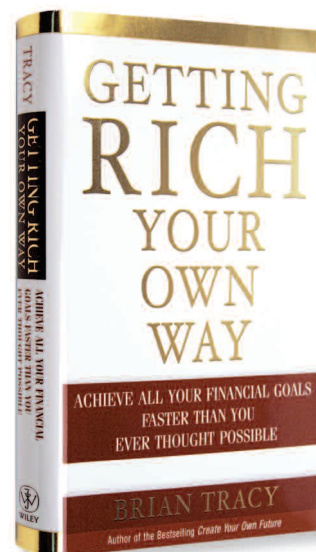
Great wealth *is* possible for those who know where to look. Brian Tracy knows where to look. By applying the principles in this book, he went from a struggling salesman to a millionaire in less than 10 years. He has helped hundreds of businesses and thousands of individuals achieve financial success far beyond their expectations.

Brian Tracy constantly travels the world, giving seminars on sales, management, entrepreneurship, business development, and personal achievement. He's the president of his own human resources company, the author/narrator of more than 300 bestselling audio and video learning programs, and the author of 35 books, translated into 25 languages.

In this summary, you will learn how to become wealthy, no matter who you are or where you're starting from. By reading about how Brian Tracy and so many others have done it, you'll learn how to get rich your own way, the way that's exactly right for you and your special talents and abilities. You'll discover that there are no real limits.

IN THIS SUMMARY, YOU WILL LEARN:

- The five major sources of self-made millionaires and 18 principles, ideas, and concepts with which to program your mind for total success.
- The five rules for starting and building your own successful business ... and how to get the money you need.
- Methods that have worked over and over for people who have gone from rags to riches in one generation.
- How to invest wisely.
- How to put your corporate career on the fast track.
- How a part-time job can help you "Follow the Leader."
- How to make your financial goals specific.
- The all-important mental attitudes of successful people.



By Brian Tracy

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THE COMPLETE SUMMARY: GETTING RICH YOUR OWN WAY

By Brian Tracy

The authors: Brian Tracy, Chairman and CEO of Brian Tracy International, a consulting and training organization, is considered one of the top professional business speakers in the world.

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Learn How to Become Rich

To achieve financial independence, maximize your assets: your specialized knowledge, skills, cash reserve, contacts, creativity, good work habits, positive personality, luck, your energy, and the right occupational choice — perfectly suited to your talents, interests, abilities and temperament. ●

Become A Money Magnet

You attract into your life the people, circumstance, and events that are in harmony with your thoughts (positive or negative). Whatever you expect with confidence — positive or negative — becomes your reality.

Your outer world reflects back to you what's going on in your inner world. So control your inner dialogue, because *you become what you think about*. Resist your fears and practice positive affirmations. These may sound strange at first, but eventually the new message will override your previous programming and become the new “operating instructions” for your subconscious mind.

People become and remain wealthy because they've cultivated a “wealthy mindset.” But negative thinking and continual worry about money will drive money away.

Take the long view. Everything worthwhile is an accumulation of countless tiny efforts and sacrifices. It will take you a long time to build your knowledge, save money, and acquire experience.

Everything counts. Every positive, helpful action goes on the plus side of your ledger; low/no-value activities go on the negative side. Everything either moves you toward the things that you want to accomplish in life, or away.

Make your financial goals specific. Then write down everything that will help increase your income by the amount you've decided on.

Then create clear mental pictures of things you want. See yourself actually doing the things that would achieve your goals.

Associate with the right people — positive, successful, ambitious, determined people — who are definitely going somewhere with their lives. Avoid people you neither admire nor respect. ●

Secrets of Successful Investing

1. If you're not worried about your investments, you're not risking enough.
2. Always take your profit too soon. Conquer your greed.
3. Distrust anyone who claims to predict the future.
4. When the ship starts to sink, don't pray; jump. Accept small losses as a fact of investing life.
5. Remember that luck is the most powerful single factor in investment success.
6. Never fall in love with an investment.
7. Never confuse a hunch with a hope.
8. Optimism means expecting the best — but confidence comes from knowing how you'll handle the worst.
9. Disregard the majority opinion. Think through every decision for yourself.
10. If it doesn't pay the first time, forget it.



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Invest for Success

For safety and liquidity, invest in money market accounts, certificates of deposit, and government savings bonds.

If you're considering the stock market, be aware that unless your knowledge is superior to that of the people who spend their lives in the market, it's dangerous to believe that you can outguess them. And yet since the market is so volatile, even the experts' advice is at best an educated guess.

Stock market investing takes time. Examine the real assets and liabilities of any company you're thinking about investing in. Ask whether its product/service is something people really want and need. Assess the quality of its management.

Mutual fund investing can put you in the stock market with minimal risk. In fact, if you keep your money in a well-chosen mutual fund, you'll be further ahead, over a working lifetime, than with almost any other investment except your own business. ●

Start with Nothing

Get your personal finances under control by "paying yourself first." Put 10 percent, off the top of your income, into your financial independence account; never touch it for any reason except to invest or grow it. If 10 percent seems like too much, start with 1 percent and work your way up. But get started.

Reverse your thinking about spending vs. saving. Associate saving with happiness and success, not deprivation and discomfort. That's the mindset of everyone who's become wealthy.

Don't lose money. Invest cautiously, conservatively, and prudently. Don't try to get rich quickly or make a killing in some area. Instead, concentrate on getting rich slowly. That's how wealthy people do it. They have very low debt, and they're prepared to spend many years achieving financial independence.

Most new businesses fail. But the failures are mainly the businesses started by *inexperienced* people. Fully 90 percent of businesses that were started by *experienced* business people succeed, because these people know how to purchase, produce, sell, market, generate revenues, negotiate with suppliers — how to make a business successful.

One way to learn business skills is on-the-job training. You can identify what you're doing right and wrong and thus get the experience you need — and be paid for it.

So go to work for another business in the industry that attracts you. Be prepared to put in five years of hard work to get the training and experience you require.

But see yourself as self-employed. The more attention you pay to your personal "company," the faster you'll grow and the more you'll learn.

Off the job, you can do research and gather information on various businesses until you find the ones that interest you the most. Learn every detail about them. Study the companies. Why are they successful? Why do they fail? What are they doing right and wrong?

If you decide to be an entrepreneur, you can maximize your sales and profitability with minimal effort and loss if you ...

- **Set specific financial goals.**
- **Offer a superior product.**
- **Start small and grow slowly.**
- **Test before you invest**
- **Grow with your profits.** Expand your business with funds that you've earned in the business, not with borrowed capital.
- **Select people carefully.** Hire slowly; fire quickly.
- **Use financial leverage** (e.g., business borrowing and lines of credit from the bank) whenever you possibly can. ●

Build Your Own Business

To ensure success, follow these principles:

- **Be very clear about exactly what your product/service does to improve the life of your customer.**
- **Offer good quality at a fair price.**
- **Always practice frugality and guard your cash carefully.**
- **Maximize your marketing.** Remember that selling is the core skill of business success.
- **Love your customers.** Customer concern is a top priority at all successful businesses.
- **Develop a complete business plan before starting.** Think through the critical issues and make sure you can get there from here.
- **Never give up.** It takes two years to break even and four to show a profit.
- **Follow the Rule of Three.** Successful new products improve on the competition in at least three ways. Most fortunes are made by providing established products

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and services — but finding a way to improve production, selling, delivery, or service in some respect. That's why the success rate for brand-new products or services in the United States is only 10 percent — but for improved products/services, it's about 80 percent.

To get into the game, start with yourself — your talents, experience, knowledge, interest, background, and education. What can you get excited about?

Look for opportunities in business publications. Once you get an idea, search the Internet for more information.

Attend trade shows and exhibitions to find ideas for new products and services.

Tell your friends you're thinking of starting a new business and you're looking for new product ideas.

You may already have a million-dollar idea in your own mind. Many people ignore their own hunches then watch someone else market the same idea and get rich from it.

Keep your eyes open when you travel. Sometimes the new product or service is doing well somewhere else but hasn't yet come to your market.

Move quickly on opportunities. Very often, all you have to do to get the rights to sell a product in your market area is to ask, but be absolutely sure that it's selling well somewhere else.

To Succeed In Business, Ask Yourself:

- Is your product suitable?
- Have you analyzed the market?
- Who are your customers?
- Why would they buy from you?
- What are the alternatives?
- What does each new customer cost?

Then ask yourself these key marketing questions:

- How does the product/service change or improve the life of the customer?
- To whom is it going to be sold?
- At what price?
- How is it going to be sold?
- Who is going to sell it?
- How is it going to be paid for, and when?
- How is it going to be produced, delivered and serviced?

Failure to ask and answer these questions can be fatal to the business. Changing any one of the answers can change your results completely.

Find something you like and believe in. You'll be successful marketing and selling something only if you believe in it, use it, and would recommend it to your best friend.

Before you introduce a new product or service to the market, be your own devil's advocate: attempt to disprove the idea that there's a profitable demand. If you can't disprove it, then your idea is marketable. ●

Market and Sell Anything

Marketing means determining what people want, need, can use, and will pay for — and then providing it in a timely and cost-effective manner.

There are four parts of any marketing plan: the product; the price; the place (Are you going to sell directly from your own company, or through wholesalers, retailers, direct mail, catalogs, or the Internet?); the promotion (advertising, brochures, packaging, salespeople, and sales methodology).

Five Cardinal Rules for Selling Anything, Anywhere

1. Your product or service must be ideally suited to the market, competitively priced, and vigorously promoted. Nothing sells itself.

2. People buy *benefits*, not products; they buy solutions to problems, ways to achieve their goals.

3. You must satisfy an existing customer want or need — or create one.

4. Customers must believe the salesperson, trust the company, and be convinced that the product/service is the best for them.

5. Customers must be willing and able to pay for the product/service and have a sincere desire to enjoy the benefits you're offering.

Every piece of advertising or promotional material must answer these questions:

- **“Why should I listen to you?”** The scarcest commodity today is attention.
- **“What is it and what does it do?”** It's amazing how many advertisements fail to answer this question.
- **“Who says so?”** Customers are skeptical, so you need proof that your product is what you say it is — e.g., testimonials, independent research.
- **“Who else has used it?”** No one wants to be the first — there's safety in numbers.
- **“What do I get?”** If a 10-year-old child cannot

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understand the benefits, then your advertisement probably won't succeed.

Start small and grow slowly. Always conserve cash.

Don't lose money.

Master the art of selling. Selling is one of the highest-paid professions in the world. People like Bill Gates, Warren Buffet, and Michael Dell are continually standing up before critical audiences and selling the virtues and values of their products and services.

Selling is a learnable skill, so the only question is: Are you going to become good at it?

Marketing and selling are the two key business skills that cannot be delegated successfully to someone else. The sooner you become excellent at selling, the sooner you'll become financially independent.

There are many ways to get free publicity when you're ready to go to market. How can you make your product/service newsworthy so that people will write and talk about it without your having to spend money advertising?

Every day, almost 3000 men and women decide to take a chance and realize their dreams of freedom, success, and financial independence. So can you. ●

Get the Money You Need

Money is available everywhere. You can...

- **Dip into your own savings.**
- **Sell some assets.**
- **Use your credit cards.**
- **Take out a personal loan.**
- **Borrow against collateral.**

• **Acquire "love money"** that people loan you because they love you. Most new business financing actually does come from friends, business associates, and relatives.

• **Get a business loan.** You'll need liquid asset coverage of two dollars for every dollar you wish to borrow.

• **Lease or rent.** Instead of paying cash for furniture, office equipment, or other necessities, you can make monthly payments by renting or leasing them.

• **Bootstrap your way to success.** Start small, generate sales and profits, then reinvest your profits into the business to generate more sales.

• **Use customer financing.** Your customers can give you the money that you need to produce the goods and services that you sell them for the money they've already paid you.

Many companies start out this way. They ask the customer to pay for all or part of the order when it's placed. If this isn't possible, they get the customer to agree to pay upon delivery, rather than waiting a month. They then take this money and pay their suppliers. By selling a product, receiving payment, and then paying your supplier, you can actually be in business with little or no cash investment or exposure.

• **Seek venture capital.** Fewer than 1 percent of business proposals received by venture capitalists are ever funded, because new businesses are so risky. Venture capitalists will invest only in a business that has a proven success record; a complete, detailed business plan; and a competent management team.

• **Consult the Small Business Administration.** The SBA will look at business plans as a "lender of last resort." It will consider your application only when you've been turned down by at least two other banks or financial institutions.

But because the SBA is a government organization, even if they turn you down, they'll help you operate more successfully, with low-cost consulting services and information resources.

• **Seek funding from Small Business Investment Companies** — groups that create pools of money to invest in small, up-and-coming companies. They too will require a track record before they'll invest with you. And they'll require equity (very often, controlling equity) in your company.

• **Issue a public stock offering.** This is one of the fastest ways to become wealthy. By building a business with a record of growing earnings, you can sell stock to the public based on a multiple of those earnings.

• **Obtain supplier financing.** Many of your suppliers will offer you delayed billing, if you ask. You can thus purchase products and services, even raw materials, to produce the goods and services that you sell to your customers — and then get paid for them — all before payment is due to the supplier.

With good credit, you can start a business, make sales, fulfill the sales, and make profits long before having to pay for the products or services that have already been sold.

There are many sources of money. What others have done, you too can do. ●

Think and Grow Rich

Each person has the seed of genius. Your job is to learn how to access your mental storehouse of ideas.

Summary: GETTING RICH YOUR OWN WAY

Why is creativity so important? First, solving problems and making decisions are the entrepreneur's key functions. The better you become at finding creative ways to solve the inevitable problems — and make effective decisions — the more successful you'll be.

Also, you move to the top only by performing higher-valued tasks, and this requires more of your intelligence and creativity.

We use only a tiny percentage of our potential mental power. By sharpening your thinking skills and exercising your natural creative powers, you can multiply the value of your efforts.

How to Work Smarter

- **Think positively.**
 - **Set clear goals and objectives.**
 - **Stimulate your curiosity.** Develop a questioning, curious attitude.
 - **Stimulate your mind with books, audio programs, and other forms of information.**
 - **Practice creative visualization.** Continually imagine and visualize your goal as if it were already achieved.
 - **Learn to laugh at yourself.** Laughter can stimulate your creativity and give you a greater sense of well-being.
 - **Get physically active.**
 - **Practice intense concentration.** Focus on one thing at a time. The more you concentrate, the smarter you become.
 - **Expect the best.** When you confidently expect that there's an ideal solution to a problem, you almost always find it.
 - **Take charge of your life.** Whenever you have any difficulty, immediately take mental control of the situation by saying, "I am responsible." This sense of control enables you to activate your higher mental powers and use more of your faculties.
 - **Develop a burning desire.** Ambition is the driving force that causes you to strive continually toward being all you can be.
- Many creative geniuses have only average or slightly above average IQs, but they use their talents in an outstanding fashion:
- **They concentrate single-mindedly.** It takes many years of concentrated, focused effort to achieve greatness.

- **They take a systematic approach.** They're continually writing and rewriting, planning and replanning. Familiarize yourself with different problem-solving methodologies so that it'll be easier for you to come up with effective solutions.

- **They keep an open mind.** Be willing to look at any subject in a variety of different ways. Practice being an "adaptive thinker." Be flexible about any problem that you're facing. Always begin with the assumption that there may be a better way.

Evaluating Your Business Ideas

Once you've generated a variety of business ideas, you must evaluate them before you commit time, money, and energy implementation. Remain objective. Ask other knowledgeable people for their opinions; listen with an open mind.

To evaluate your idea, ask: Is it effective? Would it work? Is it good enough to make a meaningful difference? Is it efficient? Is it an improvement over what people are currently doing? Can people use it without having to radically alter their behavior?

There's no point in investing in an idea that's not a significant improvement over what's already been done, or expecting people to radically change their behavior.

Finally, is the timing right? Is it practical now? Would it be practical when it's implemented? Is it worth doing? Is it simple?

For every obstacle, the solution is waiting to be found. Your success in life will be in direct proportion to how well you use your creative imagination to solve problems. ●

Learn from the Best

Seek out successful people, study how they think and act — then copy them exactly. The top people in every field all began by learning from the very best.

Five Qualities That Differentiate Successful People From Everyone Else

1. **Common sense:** The ability to reflect upon their experiences and derive general rules and guidelines that can be applied to subsequent experiences. The result, eventually, is wisdom.

2. **Intelligence:** Successful people are intelligent in ways that often cannot be measured via grades and academic achievement.

Summary: GETTING RICH YOUR OWN WAY

The highest-paid intelligences today are “social intelligence” (the ability to get along well with a wide variety of people) and “entrepreneurial intelligence” (the ability to see opportunities to create products and services that people want and need and that can be sold at a profit).

3. Expertise: The ability to do the job extremely well. Studies show that it takes five to seven years, and 10,000 hours of application, for you to rise to the top 10 percent of your field. There are no shortcuts.

4. Self-reliance: Top people always look to themselves as the primary creative forces in their own lives. They refuse to make excuses.

5. Results orientation: Top people are always thinking about results. They focus single-mindedly on getting the job done well, quickly, and dependably.

You can think like a champion. Identify the three things you do that account for 90 percent or more of your work results. If you want to move to the top of your field, begin to focus relentlessly on these three activities.

To identify the opportunities that are all around you:

1. Gather information about people and businesses in the field in which you’re interested. Become an expert. Expert power is very valuable.

2. See yourself as already successful. Combine your visualization with action. Every day, do something positive that will bring you closer to success.

3. Start small and use customer financing. You don’t need a lot of money to get started.

4. Seek common solutions — ones that can be duplicated for customers. Go after the biggest markets.

5. Assess “sellability”. Be sure it can be sold by ordinary, competent salespeople.

6. Leverage word-of-mouth. Look for a solution to a problem that really works and that can sell itself by word of mouth.

7. Seek profitability. Look for solutions that have an optimum price to cost relationship of at least 3:1.

Another way to learn by modeling is to study another successful company, since you’ll have to be at least as good as the competition — and better — to survive and prosper. So ask yourself:

How does the company attract customers? How does it sell? Who buys its product/service? How does it charge? Exactly what and where does it sell? What customer policies does it practice?

Once you learn everything you can about the top people and companies in your chosen area, copy anything and everything they’re doing to achieve success; when you originate your own successful ideas and methods, they will surely do the same to you.

Always think and talk in positive, admiring terms about the top people and companies in your industry, even as you look for ways to do them one better. Never disparage the competition.

Look for success formulas you can transfer from one industry or business to another.

Look for the areas where companies are making big profits — and concentrate in those areas. Focus on high-value-added products and services.

Discover what smaller competitors are doing successfully; consider the possibility of building an organization to do the same thing on a larger scale.

Conversely, note what the established giants are doing, and then provide customers with a less expensive alternative.

See if you can improve on the competition by using speed and flexibility to offer products or services faster, cheaper, or better. You only have to improve by 10 percent to be a success.

Always *follow* leaders. Don’t be first with a new product or service. Let other, stronger companies go through the trial-and-error process for you.

Remember that no one can copyright a good business idea. Anytime you see a good idea, take it and run with it. Sometimes the person who does that will do far better than whoever came up with it originally. ●

Lead the Field

Millions of people have achieved financial independence by getting a good job and doing it well.

You’ll guarantee your financial future if you commit yourself to (a) being paid the maximum in your field, (b) becoming absolutely excellent via continuous personal and professional improvement, and (c) saving/investing 10–20 percent of your income throughout your career.

Successful people have learned these secrets of health, wealth, and happiness:

- **Do what you love to do.**
- **Identify your core competencies.** Then organize your life around doing more of them better and better.
- **Throw your heart into what you do.**

Summary: GETTING RICH YOUR OWN WAY

- **Commit to excellence.** People underachieve because they're not getting better at what they do. They fail to dedicate themselves to lifelong learning.

- **Earn superior rewards.** Resolve to join the top 10 percent of money earners in your field.

- **Save your money.** It's quite possible to become wealthy working for someone else.

- **Do a great job right where you are.** Many people are better suited to an organizational environment where they can deploy their specialized competence and be well paid, while making a maximum contribution.

- **Put your career on the fast track** by making yourself indispensable, working harder than anyone else, and investing your extra time in opportunities for promotion, advancement, greater responsibility, and more training.

Extend your workday. You can transform your career if you simply start one hour earlier, work through lunch, and stay one hour later.

Accept complete responsibility for the results of your job. Refuse to make excuses or blame others.

Be crystal clear with your boss regarding the most important things that you do for the company. Also take responsibility for tasks that your boss doesn't like. Finally, make it clear that you want more responsibility, so that you can make a more valuable contribution.

Another way to put your career on the fast track is to work yourself into a job where the results are critical to the success of the organization — be it marketing/sales, finance, production, distribution channels, labor relations, or government relations.

Get into one of these areas. Become valuable and then indispensable. Develop specialized knowledge, learn more things faster, and constantly *network* with other people inside and outside your organization.

Talents multiplied by relationships equals productivity. Talents and relationships determine the amount of money you'll eventually be paid and how high you rise. The more people you can meet and the more talents you develop, the more successful you'll be.

Learn to speak on your feet. This is a great way to advance more rapidly in your career. The more confident you become in speaking to a group, the more effective you'll become in one-on-one conversations. Just learning to speak clearly and confidently can save 10–20 years of hard work in reaching the same levels in your career.

Be the best. If you don't like what you're doing enough to want to be the best at it, you may be in the wrong job or career.

Your job performance and income will be limited by your weakest skill. Increasing your competence in this one area will have greater impact on your overall results than anything else you can do.

All business skills are learnable. You may be only one skill away from doubling your productivity, performance, output, and income.

Develop good work habits. Focus on results. Ask yourself: "What do I, and only I, do that if done well, will make a real difference to my company?" Your answer — and your ability to focus on this answer — can advance your career rapidly.

Develop a power base. Cultivate your *personal power* (your ability to get along well with other people, to be popular and friendly, and be liked by your coworkers), *expert power*, and *position power* (from your title/rank).

Personal power comes from being a team player, working hard and well with others, and doing and saying things that make people like you and feel comfortable with you.

Meanwhile, read, listen, study, and take courses to become absolutely excellent at your job and develop expert power.

Personal and expert power will result in position power.

Obey the Law of Reciprocity. We all have a deep subconscious desire to repay other people for what they have done for — or to — us. Combine this law with the Golden Rule in all your work activities. Continually look for ways to be of service to people, thus predisposing them to help you to be successful.

Your integrity is sacred. Trust holds all relationships together, yet it's very fragile. It's based on absolute, dependable integrity. The key to gaining trust is to be *trustworthy*.

Practice the Universal Maxim. Honesty is the best policy. All good leaders were once good followers. They became leaders because others were impressed by their honesty, competence, integrity, and character. As you practice these qualities, every door will open for you.

Focus on the future. It doesn't matter where you're coming from; all that matters is where you're going.

You can become wealthy. Develop "prosperity consciousness." Think of yourself as a wealthy person in training, as a work in progress; write and rewrite your goals over and over. You can become a no-limit person. It's all up to you! ●

· Book 20 of 44 ·

Summary



An Insider's View of the Highly Competitive, Lucrative World of Hedge Fund Management

Hedgehogging

THE SUMMARY IN BRIEF

Professional investors, or hedgehogs, are intriguing animals, and hedgehogging, the never-ending search for investment acorns, often reveals the best and the worst characteristics of the species. They operate in a world of mystery and mistrust, both praised and reviled for the amount of money they make and the manner in which they make it.

Hedge funds are blamed for every spasm in the financial markets, and there is a perception that they often act together in vicious conspiracies to destabilize the world.

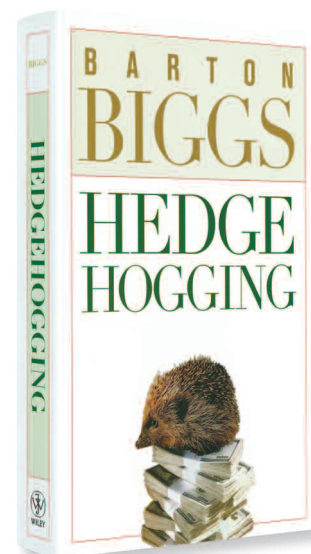
Everyone knows hedge funds have had dramatic growth. What is not fully understood is how volatile and market sensitive the hedge fund business really is.

In *Hedgehogging*, Barton Biggs shares some of his own experiences in starting a hedge fund and describes the way others have maneuvered for investment survival. He gives an inside view of the investment business in general and hedgehogs in particular, and helps the reader to understand the intensity, stress, foibles and insecurities of the men and women who manage other people's money.

The hedgehogging world is resplendent with billion dollar portfolios. It's a place where private jets are common and owning three homes is the norm. Biggs takes us inside where he profiles the players and their game with the practiced eye of one who has seen it all, done it all, and lived to tell the story.

IN THIS SUMMARY, YOU WILL LEARN:

- What it takes to be a hedgehog.
- How to look at investing as an art more than a science.
- Whether to concentrate on growth stock investing or value investing.
- What makes a great investment manager.
- Why groupthink is a disease that plagues every committee.
- Why it's prudent not to go hedgehogging alone.



By Barton Biggs

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THE COMPLETE SUMMARY: HEDGEHOGGING

By Barton Biggs

The authors: **Barton Biggs**, former chief global strategist for Morgan Stanley, retired in 2003 to become a consultant to the firm and with two other colleagues formed Traxis Partners, which soon became the largest new hedge fund of 2003.

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The New Hedgehogs, Once Golden Boys

For every hedge fund rags-to-riches story, there are at least two to three rags-to-rags or rags-to-riches-to-rags tales. In 2004, an estimated 1,000 funds went out of business in a slow, lingering death.

Typically, a couple of guys start a hedge fund and raise \$10 million or even \$50 or \$100 million. Their fee is 1.5 percent fixed on assets and 20 percent of the profits, but they can't survive on the fixed fee. They have a lot of overhead in space, accounting, computers, back office and technology. Then they have three analysts and a trader to pay salaries, plus hard dollars to fork out for Bloomberg terminals and research services. The fixed fee doesn't even cover the overhead, so there is no money left for the partners. Unless the partners have some money to begin with, they have nothing to live on. So their future depends completely on the fund's performance over the first couple of years.

If the fund does well, the partners earn the 20 percent, get more money and wear smiles to bed. If they really blow it in the first year, everybody redeems their money, and they're gone with barely a ripple. But if they just dog along for a couple of years with mediocre performance, then no new money comes in, and it's tough at the office and austere at the home: 20 percent of nothing is nothing.

Grinning Gilbert

There was a manager, known as Grinning Gilbert, who was always grinning when he talked to you. He could be telling you that his best analyst had just quit or that his biggest investment had missed on earnings, and he would be saying it with a huge, beaming smile. In 1996,

Grinning Gilbert was maybe in his early forties and laboring as a portfolio manager at Lord Abbett when he quit to form his own hedge fund.

Grinning Gilbert didn't have any money to speak of, but he hired three young analysts. He was a story stock, momentum investor, and he alone made all the investment decisions.

In the hot markets of the late 1990s, he increasingly concentrated on tech and Internet stocks. Performance was volatile, but 1997 was huge. By 1999, Gilbert was running around \$500 million and making some serious money; which he plowed back into his capital account in the fund.

Grinning Gilbert's wife Sharon is known for her aggressive, ambitious personality. She performed a full cannonball into the Greenwich social pool, which is not easy. Most of all, she began to pour money into their new \$10 million mansion on Round Hill Road.

The family moved in on July 1, 2000. Grinning Gilbert was a little nervous about the new overhead, but as long as the fund kept cranking, he figured they would be okay. Meanwhile, the firm had accumulated some additional overhead as well. There were now five analysts, a chief operating officer, a client-relations person, an office manager and four secretaries. The straws were mounting on the camel's back even as dark clouds were gathering.

For the year 2000, Grinning Gilbert's fund was down 15 percent. By the summer of 2001, the retreat in tech stocks and Internet stocks had turned into a full-scale rout and Gilbert's investors began to assail him even as they withdrew their money.

One Tuesday in October, Gilbert drove home, went up to his bedroom, drew the curtains, and went to bed. He



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put in wax earplugs, pulled the covers over his head and stayed there for the rest of the week and through the weekend. Overhead at home, overhead at the office, leverage, redemptions and a declining portfolio must have been gotten to him. The following Tuesday, Sharon went to the office and told Grinning Gilbert's traders to close all his positions (locking in a 30 percent decline) and liquidate the fund. She generally took charge talking to the lawyers and accountants. The investors were notified the following week. Grinning Gilbert never came to the office again.

Short Selling Oil

(Editor's note: Barton Biggs' hedge fund, Traxis Partners, was started at the end of 2002, with Madhava Dhar and Cyril Moulle-Berteaux, two friends he had worked with at Morgan Stanley Asset Management.)

Since there is no magic formula for investment success, the Traxis Partners' goals when they put their newfound money to work on June 2, 2003 was not to lose money in the first few months. Losing money early in the game can set a fund back by years, as the manager works to recover the losses and build up a winning track record in order to build enough credibility to make another effort at attracting new money.

The partners were tortured unmercifully by a short position (betting the price would fall) they took in oil in May 2004, when the price was about \$40 a barrel. They did all their usual analytical work and model building. Their reasoning went like this: Other than a brief war-related spike in 1990, both the nominal and real price of oil were back to the highest levels since the early 1980s. World production and inventories were rising, and the strategic oil reserve was nearing peak capacity. Consumption, they postulated, was probably decelerating as both the world and the Chinese economy slowed. The regression model that the partners constructed showed the fair price of oil as \$32.48. Most energy experts maintained it was even lower, pricing out somewhere in the high 20s.

Deep Analysis Can Get You in Trouble

The analysis was for naught, they misjudged demand, failed to anticipate the intensity of the hurricane season and political developments, and were less respectful than they should have been of market psychology and its effect on price momentum. Oil rallied to over 42, then later fell to 36. The partners' analysis indicated that oil was still materially overpriced and they didn't want to lose their position. But, they were wrong. Oil prices proceeded to climb as terrorism and sabotage in Iraq, a tax

dispute in Russia, a strike in Nigeria, and a presidential recall vote in Venezuela roiled the market for crude. Convinced that these were temporary disruptions, they increased the size of their short position.

In the partners' process, when the price of an investment goes against bias by more than 15 percent in the case of a commodity, it triggers an automatic review of the fundamentals. Following that review they either have to add to the position or close it. As value investors, if the fundamentals have not changed, their inclination is to add to the position, not close it, because the price change has actually made it more attractive, not less.

On August 19, the price of oil hit 48, equity markets were reeling, and the partners were down 7 percent for the year. The next day *The New York Times* ran a story that reported Traxis was suffering substantial losses from its oil short.

Immediately a storm broke. One of the largest investors, who had committed to Traxis right at the beginning, called to say he was withdrawing. A fund of funds e-mailed the partners to say that they were crazy and were violating their fiduciary responsibilities. A woman, whose money had been successfully managed by one of the partners for 30 years, called to say she couldn't take the volatility and wanted out.

Thirty years of confidence went down the drain in a couple of months, even though in 2003 the fund had performed really well. ●

The Odyssey Of Starting A Hedge Fund

Morgan Stanley graciously offered to assist in the start of Traxis Partners, both with the back office operations and in the marketing of the fund. At the start of the long climb up the hedge fund mountain, there was a strong suspicion by the partners that there would be an abundance of stress, strain, anxiety and maybe ecstasy.

Starting a new hedge fund is a desperate, frantic adventure. The founders have to spend their own money to acquire office space and create the administrative, trading, accounting and legal infrastructure of a business, hire analysts, traders and a chief administrative officer. However, their primary objective must be to meet prospective investors and raise capital.

Big-Time Money Raising at The Breakers

On March 2, 2003, the odyssey of raising money began in Palm Springs, Fla. at Morgan Stanley's famous hedge fund conference at The Breakers. This confer-

Summary: HEDGEHOGGING

ence is widely considered the prime event at which to raise money because it attracts the biggest, richest collection of hedge fund buyers in the world. The intensity and hustle level were incredibly high. Everybody was on the make.

The presentations were grindingly repetitious. The audience members included the professionals, who came from the big funds of funds, foundations, endowments and pension funds. The rest were amateurs, mostly wealthy individuals and small, wannabe funds of funds.

Superstar hedge fund guys have a surfeit of capital and don't deign to appear at conferences. It is only the struggling mortals who want money who come hat in hand. The superstars have marketing managers who organize their own annual meeting with investors, complete with elaborate presentations by the messiah himself and his entourage.

The money managed by hedge funds grew from \$36 billion in 1990 to more than \$1 trillion by the end of 2004. Many new entrants try to buy their way into the business by poaching people. Some large hedge funds, in an effort to spread the wealth around, have more than one prime broker.

The Fund of Funds is a Tough Customer

A fund of funds typically selects and manages a diversified portfolio of hedge funds that it sells to individuals or institutions that don't feel capable of making the choices and monitoring the funds themselves. They run all kinds of analytics on the individual hedge funds and on their overall portfolio to monitor risk and exposures.

Prime Brokers:

Prime brokers provide securities to cover short sales, make margin loans, clear trades, provide reporting services and custody assets, provide research and help with money raising. A fund's prime broker executes roughly 25 percent to 30 percent of its hedge fund clients' transactions.

Prime brokers earn from commissions and order flow, and hedge funds now account for about one-third of total trading volume. Hedge funds are also a captive source of demand for the lucrative securities and margin lending activities from which a prime broker locks in a fat spread.

Prime brokers legally can only introduce hedge funds to prospective investors; they can't actually make pitches or solicit clients.

The funds of funds employ sophisticated quantitative analytics to add value by strategically allocating among the different hedge fund classes. The hedge fund universe is usually broken down in seven broad investment style classifications. These are: event driven, fixed-income arbitrage, global convertible bond arbitrage, equity market-neutral, long/short equity, global macro, and commodity trading funds. Each has its own, unique performance cycle. Each year the allocation among classifications will be different.

Most funds of funds focus not just on the raw performance numbers, but also on the sociological factors. They monitor whether the successful hedge fund managers are getting lazy as they get richer. They watch for divorces, third homes and falling golf handicaps.

The professionally managed funds of funds are worth the double fee they charge. For amateur dabblers, they are essential. The numbers show that the funds of funds do a good job of picking the better horses and avoiding the losers. To a certain extent, the funds of funds have to make life difficult for the hedge funds they invest in to justify their fees.

Professional investing is about performance, just as professional sports is about winning. However, the obsession with short-term performance is never good, either for investors' returns or for investment managers' performance. There is an element of luck in the investing game. Even the best investors have slumps. In fact, the best time to invest in a good fund is after it has had a bad patch — as long as nothing has changed. ●

Hedgehogs Come In All Sizes And Shapes

Being an investor — actually running other people's money — attracts men and women who tend to be intellectually self-confident and opinionated. A questing mind, the gambling instinct, and the ability to make tough decisions on inconclusive evidence are all essential characteristics.

Tim, a Top-Down Global Investor

Tim, a legend in the hedge-fund business, had the best record of any major hedge fund in the world for most of the 1990s. It is likely that he runs more than \$1 billion, probably half of which is his. On his beautiful Chippendale desk sits a small plaque, which says *totis procis* — the whole hog. There is also a small porcelain pig with a label that reads, "It takes courage to be a pig." To get really big returns, you have to be a pig and ride your winners.

Tim is a macro or top-down global investor. He concentrates on asset classes, countries, and major groups of stocks. Tim uses immense leverage, practices enormous concentration, and has no investment organization. Leverage means volatility, and it means that you have a lot less margin of error. Tim could easily have his fund leveraged up four times. That means if he loses 10 percent on his portfolio, his equity is down 50 percent. Once you are down more than 20 percent, it's hard to recover because you are compounding off a much lower base. Suppose Tim was down 10 percent overall, but down 50 percent on his equity. If he was up 10 percent the next year, he would still be down 25 percent from inception, whereas on the same performance the unleveraged fund would be down only 1 percent.

Vince, the Bearded Prophet of the Apocalypse

Vince was the head trader for the biggest hedge fund in the late 1970s; he is now retired and runs his own hedge fund. Vince thinks of himself as a prophet of social and financial change. Prices and society gravitate around a central value and in the long run revert to the mean, he believes, but human nature is wildly emotional and thus prone to disorderly excesses that cause booms and busts. To him, the excesses of the 1990s have only begun to be purged, and the secondary consequences will be a social and financial revolution that will destroy another huge chunk of paper wealth and transform society.

Jake, a Superstar Investor

Jake's fund is around \$5 billion, and he does the macro overlay. He has maybe seven or eight asset class (like biotech, Asia, junk bonds, Europe, emerging markets, etc.) portfolio managers who each run anywhere from \$100 million to \$400 million, depending on what Jake's view of their sector is. Jake creates performance by allocating between the asset classes, and, in theory, the other guys add additional alpha by doing even better than their sector index. Jake believes in effective time management and limiting babble. He is famous for short conversations with babblers. If somehow you get through to him, he just listens for a few minutes, says nothing back, then says, "Thanks" and hangs up. ●

The Violence Of Secular Market Cycles

What makes investing so difficult and dislocating is that it has violent, long boom/bust secular cycles, which can occur once in a generation.

A secular bear market is a decline in the major stock averages of at least 40 percent — and considerably more in secondary stocks — where the decline lasts at least three to five years. By contrast, a cyclical bear market is a fall of at least 15 percent but less than 40 percent that rarely lasts more than a year. A panic is a very short, sharp break.

The long cycles in the U.S. equity market in the last century could be defined like this: 1921 to 1929 — secular bull market; 1929 to 1949 — secular bear; 1949 to 1966 — secular bull; 1966 to 1982 — secular bear; 1982 to 2000 — secular bull. The new secular bear market began in 2000 and we are now in a cyclical bull market rally.

How long it will be this time before stocks begin a true, new secular bull market is very difficult to guess. The conditions for such a renaissance are that money should be cheap and amply available, the debt structure should be deflated, there should be pent-up demand for goods and services and, probably most important, stocks should be clearly cheap based on absolute valuation.

The Bliss of Starting Fresh

An investor, hedge fund or otherwise, with nothing but cash, is forced to focus on fresh opportunities and is compelled to buy the 20 or 30 most attractive positions to be found as of that moment. Hedge funds that survive do best in their first year.

In contrast, when you are working with an existing portfolio and reshaping it, there are unrecognized, subconscious, emotional hang-ups that block you from impartial, cold-blooded investment actions like selling. Your baggage is what you already own, and it gets in the way of excellence.

Investors often personalize and become emotionally involved with positions when the investment decision-making process should be completely intellectual and rational. There is no reward for being a faithful holder. It is the holds that are too cheap to sell but not attractive enough to buy that make a portfolio stale and retard performance. ●

The Battle For Investment Survival

Private equity and venture capital have sustained their allure. Pension funds and fiduciaries are still scrambling to get more money into venture capital, even though at the end of 2004 there was an overhang of \$54 billion of allocated — but uninvested — money in the hands of venture capitalists.

Summary: HEDGEHOGGING

There is so much money looking for deals that valuations are once again ridiculous. This is good for the United States and great for innovation because entrepreneurs will get funded, but bad for the investors because high entry valuations mean low exit returns.

Global private equity firms were estimated to raise \$200 billion in 2005, four times what they took in the previous year. Returns were speculated to reach 15 percent to 20 percent. Why would any fiduciary do anything else with their money?

David Swenson of the Yale Endowment maintains that in private equity the poor and mediocre performers stay that way. Just being in the asset class won't do it. It's very important to be with the real pros.

Since its inception in 1973, Yale has earned an astounding 30.6 percent per annum from its private equity program, but there has been immense volatility in both the one- and five-year returns. When there were years of red ink, and the conventional wisdom was that private equity was caput as a high-return asset class, that was the time to double commitments, proving that staying power is absolutely essential.

The Five Basic Principles that Yale Endowment Manager David Swenson and Co-Worker Dean Takahashi Stick to:

1. They strongly believe in equities. As investors, they want to be owners, not lenders.
2. They want to hold a diversified portfolio. Their conviction is that Yale can more effectively reduce risk by limiting aggregate exposure to any single asset class rather than by attempting to time markets. No attempt is made to fine-tune allocations until valuations become very extreme.
3. Greater incremental returns are achievable in selecting superior managers in nonpublic markets that are characterized by incomplete information and illiquidity.
4. They are convinced Yale should use outside managers for all but the most routine or indexed investments. The staff knows its investment managers very well.
5. Swenson is disinclined to use investment management firms associated with investment banks and mutual funds because of the potential conflicts. He wants his investment firms to be owned and managed by the people who are doing the actual investing.

Swenson argues that LBO (leveraged buy out) firms that concentrate on improving the operating performance of their portfolio companies consistently do far better than those that just leverage up troubled businesses. He makes the point that the investor in LBO firms in general is not compensated for the extreme risk of leverage and the immense nonliquidity.

It is hard to structure an investment organization that can adapt to the ebb and flow of investment talent over even a couple of generations, much less centuries. The message derived from the Yale endowment history is that the main individual (or perhaps individuals) who run the portfolio is the absolutely crucial choice. A committee can't do it. A committee can be instrumental in picking the individual, but it can't get involved in actually managing the asset allocation of the portfolio. Their consensus wisdom is bound to be wrong. ●

Nature's Mysticism And Groupthink Stinks

Groupthink is the disease that plagues every committee. Investment teams and committees, when they disagree about the proper course of action, can become paralyzed by respect and politeness.

In a big investment management firm that has to function through an investment policy committee, the chances for good decisions are best with a leader who meets regularly but informally with a small group of trusted advisers (three to five is the right number). The small group chews over the issues and the leader may poll it, but, in the end, the leader makes the decisions and is responsible.

A large group that votes democratically sounds good because it encourages participation, but in investing, democracies don't work. In fact, they invariably fail. Decision making and responsibility has to be located in an individual.

Solothink is where one very strong, very successful individual dominates the investment decision making, and can be just as dangerous as groupthink because it can become authoritarian and tyrannical.

A firm is particularly vulnerable to solothink when the predominate investor is also the rainmaker and the boss, but even committees can be dominated by a strong individual who others are reluctant to challenge.

As business organizations, investment management firms and hedge funds are particularly vulnerable to solothink. As long as the investment messiah can keep walking on water, everything is fine, but if the messiah loses

his touch, performance is so measurable that he can lose his halo very quickly.

In general, all investment organizations work best when they are relatively small, and when the principals like and trust each other. Decision making is the most important part of the investment process. Groupthink and solothink are elements to consider when organizing a group for effective decision making. It's not easy. ●

Once You Have A Fortune How Can You Hang On To It?

Preserving and enhancing your fortune is a demanding task that most people fail. Sam, who earned a lot of money selling his own company, has been successful at enhancing his fortune. His philosophy dictates that all returns should be looked at, above all, after taxes. Returns are reported pretax and thus are an illusion, because achieving high after-tax compounding is what the exercise is all about. Liquidity and transparency of the investment vehicle are critical. Sam likes to keep it simple. He invests in hedge funds that have active strategies — that go for it. He is willing to live with the volatility.

What has worked for Sam is finding a handful of great, enduring funds, knowing the managers well, concentrating on them, and staying with them. He looks for large funds with stable management that will outperform in up markets and protect capital in bad ones. You have to recognize they don't make money in down markets and they deliver a big tax bill.

Sam has two-thirds of his money in hedge funds. He does think every wealthy person ought to have a lifestyle reserve in high-grade tax exempts. How big that reserve should be depends on the age and wealth of the individual. "Ideally," he says, "it ought to be enough to support you in a basic, affluent lifestyle if the stock markets crashed and stayed busted."

If You Go Hedgehogging by Yourself

To have hedge funds as your core holding, you should have a portfolio of at least five funds and preferably 10 — five main managers and five on the farm team. You must spend serious time studying them, calling on the managers occasionally, and probably going to conferences. Doing hedge funds yourself is hard work. You must research your investments and understand their investment process. Unless you are willing to do this diligently, you should use a fund of funds to invest in hedge funds. Well-managed funds of funds keep up with the

S&P 500 in good markets, preserve your capital in down markets, and do this with lower volatility.

Investing in Fine Art

Just as with equities, the returns from owning art depend mostly on how individual pictures stand the test of time and fashion. The bear market in art seems to be over, and prices in general are rising again, but the craziness has not come back — yet. With yields on financial assets so low, the income loss from owning art is much less of a deterrent than it was 10 years ago. On the other hand, CEO hubris and greed scandals have effectively eliminated the corporation as a collector in the United States and Europe. The bubble has been popped, and prices are rising again in a more orderly manner.

Hedgehogs are big buyers of art today. Some of the acquisitions are trophy collecting; a not so subtle form of bragging. Buy a picture because you love looking at it, not as a diversifier or as an investment. ●

Three Investment Religions: Growth, Value And Agnostic

Growth stock believers argue for stock in companies whose earnings and dividends are consistently increasing. Ideally, growth stock investors want to hold shares in great businesses, and they sell only when the business itself falters, not because the price of the shares has risen.

By the time you can clearly identify a stock as a growth stock, it usually will already be valued accordingly. Therefore, you end up buying the expensive stocks of good companies.

Growth stock investors are also inclined to fall in love with their growth companies that have treated them well. Sell growth stocks when they become outrageously expensive.

Value investors want to own stocks that are cheap, not only in relation to other equities, but also in absolute terms. By buying cheap, a value investor creates a margin of safety for his investment. They search for the under-owned, unloved and undervalued.

Value stocks, by definition, are cheap in relation to their assets and earning power because investors are pessimistic about them.

Agnostics say that everything in the investment business is temporary. When growth stocks are relatively cheap and the economic environment favors them, agnostics will own growth. When value is cheap and growth is expensive, they will look for value. Sometimes they will own a little of both.

Summary: HEDGEHOGGING

Growth investing, because of its bias toward a buy-and-hold strategy, is inherently more tax efficient. However, for tax-exempt investors, the hard evidence is that the actual portfolios of value managers beat those of growth managers.

It is interesting to note, that, during one of the great speculative growth stock bubbles of all time, only in 1998 and 1999 did growth absolutely bury value. ●

Bubbles And The True Believer

Since time immemorial, the financial markets of the world have been prone to bubbles in everything from tulips and art to shares and houses. Therefore, obviously it is very important for investors to understand them.

All bubbles start as powerful fundamental developments and legitimate investment opportunities. They become bubbles or manias when investors in their euphoric optimism project future results, not based on the rational fundamentals, but on a continuation of past results.

There are two general varieties of bubbles. The happier varieties are bubbles in securities of productive assets like technology, railroads, and stocks and bonds. The bad kinds of bubbles are in nonproductive assets like tulips, Tokyo golf courses, real estate or collectibles when the bubble's assets are used as collateral for loans from banks.

The most dangerous of all is a bubble that sucks in a large percentage of the population of a country, such as a bubble in residential real estate. However, a housing bubble is slower moving because the price appreciation is not so readily apparent and because it spreads by word of mouth.

When a bubble in nonproductive assets financed by banks bursts, the consequences invariably are deflation and depression. It is very difficult to figure out when bubbles are going to burst. Valuation and overbought technical metrics invariably signal the bust far too early. Observing market action doesn't help either.

When a bubble finally bursts, the so-called fallacy of composition comes into play and inflames mob psychology. This theorem says that, in a crisis the action that is rational for each individual is irrational for the group as a whole and creates a disastrous outcome. In a financial panic, each individual is acting rationally when he sells his stocks, or would be were it not for the fact that others are doing the same thing. Each participant, by rationally trying to save himself, contributes to the ruin of all.

The True Believer: Disciple of Gold

Peter lives in Sun Valley, Idaho and runs an investment-management company/hedge fund that specializes in gold. He came up with gold because it was complex, misunderstood, under-researched and susceptible to his option-pricing theories. He became the most knowledgeable gold analyst in the world.

Gold has a negative yield because you have to pay for storing it, there is no intrinsic valuation equation, and its only worth is as expensive apocalypse insurance. But Peter's search for an asset class to immerse himself in led him to gold.

The stock market explains 88 percent of the weekly price fluctuations of gold over the past eight years. The long-term correlation with Treasury bonds is not as high but still very significant.

As Peter explains it, the so-called problem with gold, which causes its erratic price behavior, is that "the elasticity of a positively sloped investment demand function overwhelms the inelasticity of supply." Translated, only 18 percent of the gold mined throughout history is held in investment form, or slightly more than \$200 billion. The investable capital markets of the world are estimated to be about \$60 trillion. In a low return cycle for stocks and bonds, monetary and investment demand for gold turns positive, and there is a dramatic shortage of available metal. This large differential can only be solved by much higher prices. The point is that it is not inflation or deflation that is the principal driver of gold, but the return from other long-term financial assets, particularly equities.

How much you should have in gold as an investment, as opposed to a trading basis, depends on how long-term bullish or bearish you are. Owning some gold shares is a wonderful diversifier. Gold goes up when stocks and bonds go down. But there doesn't seem to be much point in owning gold, the metal, outright except as a trading sardine.

Conclusion

Intelligence, experience, diligence, a knowledge of history, an open mind and an obsessive nature are all important ingredients for the successful hedgehog — as are intuition, imagination, flexibility and maybe just a touch of the seeing eye. There is no checklist, no one single model for a long-only investor or hedgehog. But to flourish, the professional has to relish and be invigorated by intellectual competition and be able to handle stress and adversity.

It's hard to be a hedgehog and it's far from easy to be a user of hedgehogs. Good luck. ●

· Book 21 of 44 ·

Summary



How to Get In and Out of the Market with Huge Gains in Any Climate

Hot Trading Secrets

THE SUMMARY IN BRIEF

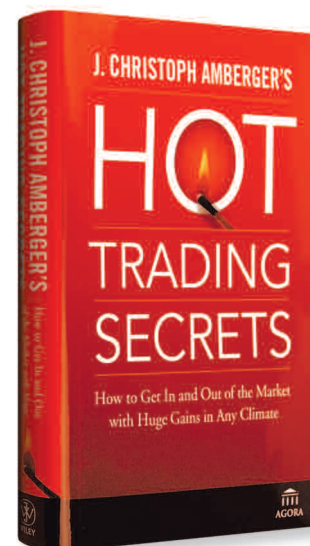
In *Hot Trading Secrets*, financial publishing executive J. Christoph Amberger reveals short- and medium-term trading secrets that will enable you to prosper in any financial climate. Amberger's methods have been tested over time in his company's newsletters, often achieving amazing results in widely varying market conditions. He promises that by applying these powerful secrets, you too will be able to master the market for maximum profit. Traders — from the novice to the veteran — will find *Hot Trading Secrets* to be both practical and profitable.

With refreshing wit and accessibility, Amberger explains how his company's investing and trading philosophy works; how over the years he has established one of the best batting averages in the financial publishing industry; and what methods and tricks his analysts use to create superior profits not only in days of global crisis, but day in and day out. These methods can help you profit handsomely in the markets in the coming years, independent of where the various domestic and international indexes are headed.

Hot Trading Secrets offers a blueprint for making money in the market today. What's more, you'll discover secrets for making money that you can apply to any market: up, down or sideways. In fact, you'll see it can be as easy as reading a road map. All you need to know is how to anticipate the unexpected turns.

IN THIS SUMMARY, YOU WILL LEARN:

- The predictive power of Dynamic Market Theory.
- How to legally and profitably trade on "insider information."
- Why you need to cast a wide net.
- How to make extreme volatility trades.
- How to out-trade the floor traders on the Chicago Board Options Exchange.
- How to profit from the "Red Zones" in newly listed stocks.
- How to become a stone-cold profit predator and win in emotional markets.



by J. Christoph Amberger

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THE COMPLETE SUMMARY: HOT TRADING SECRETS

by J. Christoph Amberger

The author: J. Christoph Amberger is the executive publisher of the Taipan Group LLC and vice president of Agora Inc. in Baltimore, Md. Born in 1963, he grew up in what used to be West Berlin, Germany, and was educated at the Freie Universität Berlin, the Georg-August-Universität Göttingen, the University of Aberdeen (Scotland), and St. John's Graduate Institute in Annapolis, Md. Since 1988, the Taipan Group has researched, compiled, and published independently assessed information and opinion in its flagship publication *Taipan*, a small-circulation bulletin available by private subscription only, *247profits e-Dispatch*, and affiliate publications and Web sites.

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Dynamic Market Theory

Our trading philosophy is called Dynamic Market Theory. Much like the theory of evolution, it is based on an explanation for a set of facts that has been repeatedly tested and that can be used to make predictions about those phenomena. Like evolution, our system is subject to change. A new pattern emerges, with different segments that, at least for a time, can be analyzed and translated to create the basis of yet another, modified trading strategy. The principal insight of our Dynamic Market Theory is that you need to *stop caring whether it's a bull or a bear market*. After all, who needs a bull market anyway when there's plenty of opportunity to make money all over the world?

Money, Markets and Mayhem

Keep this in mind: Those who are made nervous by crisis and upheaval shouldn't be trading in the financial markets. Successful investing isn't always pretty. If you win and you make money, it's because the other guy lost. And if he wins, you lose. And consider this: A 25 percent loser requires a 33 percent gainer just to get back to even, and a 50 percent loss demands you double your remaining money to break even. That said, you can also make huge gains with relative ease by putting your money into the right kinds of stocks *at the right time*.

If you want to come out ahead in the market, you need to be mobile, motivated, and disciplined. Maintain a healthy emotional detachment from the stocks you buy and be ready and willing to get rid of them at the drop of a hat. After all, every 200-point rise and fall

spells a double 200-point profit opportunity for those who know where to look — and who have the guts to take profits whenever they can make them. The message is quite simple: *There is always an opportunity to make exceptional stock market profits independent of where the domestic indexes are headed — as long as you know how to read the signs.*

Cast a Wide Net for Maximum Profits

Forget about finding that one great investment that you can bet the rest of your life on. For instance, is “buy gold” really the only answer to burgeoning American household debt, a declining U.S. dollar, or the rise and fall of equity valuations as Bill Bonner claims in his book, *Financial Reckoning Day*?

It is part of a prudent diversification of assets to keep maybe 5 percent of your portfolio in bullion. But gold is just an asset, one out of many that can be harnessed to build wealth in the Dynamic Market environment. And the more asset groups you include in your view of the markets, the better your chances to have one or several working for you at any given time.

This is the principal insight of Dynamic Market Theory: Cast your nets wide enough, and you will be able to profit handsomely from the major and minor fluctuations — upward and downward — of equity markets, international indexes, currencies, hard assets, real estate and technologies. Supplement short- and medium-term profits with long-term protective strategies, such as calls or puts on individual indexes. And most importantly, don't get overly enamored



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with any particular investing philosophy.

Value Explained

If, as traditional wisdom holds, real value is what investing is all about, it begs the question: What is value? For all intents and purposes, value in the stock market is the device by which we judge our relative successes and failures, moods and attitudes, and the effectiveness of our own judgment and timing. Stocks are about more than intrinsic value. They're about human behavior, human progress, and human ideals.

Value — what a thing is worth, and why — is the heart of Dynamic Market Theory. Once you understand the way value really works in the stock market, you can avoid the misconceptions that cost investors trillions in the crash of 2000, and begin to see your portfolio's worth climb steadily upward.

To begin with, the *traditional* measures of value for investors all have to do with the actual or potential earnings of a company. What is it producing? What are its costs of production? What is its position in the marketplace? What is its competition? What is its future potential for earnings? How much merchandise can it possibly sell, and at what profit margin? Is its market growing or shrinking? We must have some means for making consistent and *informed* value judgments. But, oddly enough, few investors these days seem to care about traditional value anymore.

In fact, based on our research into Dynamic Market Theory, *the traditional views on value are all wrong*. Most market theories deal with the intrinsic value of stocks or other commodities — in other words, the notion that the value comes from within the thing, and that it has value in and of itself, regardless of any association with other things. But for investors, *the only value of any importance is the value that someone else places on a stock, commodity, or investment at any given point in time*.

Bursting Bubbles

At its core, a bubble is an argument about value — mostly made in retrospect, after a particular investment fad has gone bust. But — and here's what most investors don't seem to realize — all figures of market valuations are assignments of value based only on what a small percentage of shares trades for. Only a tiny fraction of a given company's shares are in play at a given time. So the valuation commonly given to any or all stocks is more or less arbitrary, not real, even if it is based on the latest sale of a few shares of the stock.

The bubble is a natural phenomenon that occurs when a large number of human beings attempt to better their current living conditions. Seeking gains and profits, whether by emigration, by discovery or by investing in a bull market, is not at all irrational. To the contrary, it would be irrational not to. Because gains generated — and taken — during bubble events are just as real as those generated in a bear market.

In both cases, the operative term is “gains taken.” For gains to materialize, however, you must find and invest in an asset that is growing in value, and sell before it declines in value. The trick is to first find out what exactly the catalyst is that speeds the reaction in an upward direction, and then to identify the point in that process where the reaction is about to “run out of steam.”

Trading Profitably

Dynamic Market Theory is simply a common-sense approach to handling your money and your portfolio.

Since 1988, the Dynamic Market Theory team at the Taipan Group has made piles of profits by holding true to a single core belief about investing: The truest and best investments are found where no one else can see value. That sounds obvious, even fundamental. Nevertheless, from 1998 to 2001, just by following advice based on the principles of Dynamic Market Theory trading systems, you could have averaged 271 percent gains on your total portfolio.

Incidentally, did you know that 80 percent of money managers and investment advisors and 95 percent of bond fund managers underperform the market? ●

Crisis and Opportunity in the Global Markets of 2006-2009

The Last Phase of the Bubble Market (2006-2009)

No bull market lasts forever and the end of this one will be orchestrated by global forces that have already embarked on a course that will shatter our profitable little bullish idyll by the time the first decade of the new century is wrapping up. In a worst-case scenario, you have less than five years of a strong bull market to get your house in order, to get ready for the tough decade and a half that will follow the collapse of this last great bubble boom sometime in late 2009 or 2010.

Europe's Long Decline and China's Coming Collapse

The European Union is the envy of the world until you look at the numbers. Steeped in the welfare mentality that took hold in Europe in the 1970s, many European countries have government pension systems that seem to Americans to be overly generous and enviable: Spaniards continue to receive 94.7 percent of their average paycheck at retirement, while Austrians are guaranteed 93 percent. As a result, 90 percent of Europeans rely completely on government pensions to see them through retirement. This is causing a problem beyond the obvious number crunch.

Most European countries use a pay-as-you-go pension system. Pension funding comes out of current tax revenue, so, in order to maintain the current pension system, taxes will have to escalate each successive year in order to meet the government's obligations. Where is that money going to come from?

As dark as Europe's future looks, China, which has the world's fastest growing economy, will trigger the first big global economic crisis of the 21st century. The collapse of the Chinese Wirtschaftswunder (economic miracle) will come within 18 months after the Olympic Games of 2008 in Beijing. Below the surface of an exploding GDP growth and record-breaking exports, not all is well in China.

China already borrows more as a percentage of GDP than the United States under the second Bush Administration and China's banks — much like Japanese banks in 1991 — are buckling under a heavy load of non-performing loans. The Chinese government is currently attempting to overhaul the Big Four state-owned banks, which hold 55 percent of China's total banking assets, but they are weighed down with more than \$500 billion in bad debt owed by ramshackle state-owned enterprises (SOEs) and corrupt bank officials. And just like Japanese banks in the 1980s, Chinese banks are at the core of a highly speculative real estate bubble.

In the future, under the terms of the WTO, China's banks will face stiff competition starting in 2006. There will be additional pressure on the Chinese financial system caused by the triple strains of hosting the 2008 Olympics, speeding along its space program, and continuing the military buildup while footing the bills for increased social costs.

Now is the time to use the strong upside moves of the boom to build the foundation of your financial survival: Get rid of debt and pay off your mortgage, free up the income and effort required to service both, and channel them into wealth-building strategies. Get in shape and eliminate health risks that will otherwise drain your wealth at a time when you can least afford it. Look for income-generating investments, producing rent, interest, dividend, or yield income that you can use as "wealth engines" that will substitute for income generated by your current work. Most of all, once you've covered your bases, set aside an amount of speculative capital that you can use to learn the ins and outs of the trading secrets that follow. ●

The Trading Secrets

Profit From Cyclicity

To survive and prosper in the changing market climates that lie ahead, you will need to understand this: Markets are the compound reflection of human attitudes and desires and are as such as much a part of nature as man himself. They are subject to certain recurring patterns that are as predictable as natural cycles of growth and contraction.

This insight is the ultimate secret of seasonal cyclicity trading. In consumer terms, we can find cyclicity all around us. The time to buy Christmas decorations is the week between December 26 and December 31 in any given year. March to May are good months to get bargains on furniture. Between June and August, you can stock up on beach gear and cheap menswear, as long as you shop before and right after Father's Day. And between September and November, in the model changeover period, your chances are good for finding a favorable price on a new car of last year's vintage.

The concept of seasonal trades is nothing new in the commodities futures market either. There are specific seasons of the year when functions have to be performed within a clearly defined time frame including sowing, planting, growing and harvesting of crops. At the bottom of this predictive science is the phenomenon of cyclicity. Markets and populations move according to long-term cycles, each of which can span decades and even centuries.

So how can you make trading cyclicity a cornerstone of your financial survival strategy? Market seasonality features a number of catalysts that create opportunities that

Summary: HOT TRADING SECRETS

appear with predictable recurrence. Here's a short synopsis of seasonal profit opportunities that are offered by the markets almost every year:

The January Effect: In more than two-thirds of all Januaries since 1926, the stock market has gained in value.

St. Patrick's Day Green: The average person, according to a National Retail Federation survey, planned to spend \$27.65 on the holiday. The stocks to buy during the St. Patrick's Day season are retailers.

The Monster Index: (MNST: Nasdaq) In November and December, online job postings have a history of falling because of the holiday season and Monster.com stock plunges along with them. Sell Monster short based on this cycle and you can create handsome profits.

Back-to-School Profits: Every year from 2001 through 2004, Varsity Group (VSTY: Nasdaq) rose from mid-December through January, and from mid-August through September — and by an average of 75 percent. There is a simple reason for it. Varsity Group is a clearinghouse for used course books.

Once you know which stocks will move and when, all you have to do to make money is invest ahead of that move. Cycle research is key to finding these gems. And remember, the cycle indicates not only when to buy, but also how to time the sale. Within the grand overall market climate, seasonal cyclicity creates micro-pockets of opportunity.

Follow the Money

Our research team focuses on roughly 1,000 lesser-known small-cap high-tech and biotechnology companies with the most potential for breakthrough deals and announcements. Because their trading volume is generally light, any sudden surges are very noticeable.

We never profit from insider information, but we are observant. When we see sudden unexplained volume activity surrounding a once-quiet stock, we look to see if there's any current news on the company. If everything seems normal and quiet, that's when we know something big is up. The system we developed around this volume spike indicator allows us to catch anywhere from 35 to 75 opportunities each year. Insider information has a way of leaking out.

Profit at the Speed of News

One of our Dynamic Market Theory specialist teams generated 41 percent and 253 percent gains in just four

days on just one single play in Monster.com puts. The key to returns like this is what we call extreme volatility. In a way, extreme volatility works a bit like the volume spike indicator of the preceding trading secret: It revolves around inside information that moves stock prices. This system uses the Internet (and other sources) to access the information affecting the market including:

- Insider buying
- Buybacks (repurchase agreements)
- Stock splits and dividends
- Disseminated rumors
- New product or major contract
- FDA approvals for new drugs
- Successful clinical trial for drugs
- FCC license grants
- Big government orders

Profitable Examples Made by Our Profit at the Speed of News System:

Gigamedia, bought June 5, sold July 8, plus 40 percent. *The story:* Something looked to be taking shape in the Gigamedia camp. Volume jumped to six times the average on June 5, on news that management was attempting to negotiate with the company's directors to take it private. While the company decided to reject the management buyout offer, we walked away with a cool \$4,000 profit on every \$10,000 risked.

Lynch Corporation, bought July 2, sold July 8, plus 11 percent (on top of a 24 percent gain in one day, June 23 to June 24). *The story:* Insiders were tripping over one another to pick up shares and the company had just got three multimillion-dollar orders for capital equipment. We played this one twice in two weeks for profits of 24 percent and 11 percent.

CPI Aerostructures, bought June 27, sold July 8, plus 20 percent. *The story:* With insiders laying down \$73,000 for 10,000 shares of their own money, the *Extreme Volatility Speculator* editors knew something had to be brewing. You simply do not put that kind of money on the table if you think your company is down for the count. Sure enough, the company released news that it had received \$19.4 million in contracts during the first half of the year, up 46 percent from the past year's numbers, giving us the opportunity to walk away with a cool 20 percent gain in less than two weeks.

Summary: HOT TRADING SECRETS

- Joint ventures
- Commercialization of new technology
- Spikes in volume, message board chatter
- Senseless stock or sector sell-offs
- Bidding wars

Everybody knows stocks eventually go up following events like this, but average investors don't move fast enough. There is always a window of opportunity when just a few people know and before millions of people find out.

The Stone-Cold Profit Predator

Thus far, we have been looking at patterns created by human greed. The downside to greed, of course, is the other dominant human emotion: fear.

Look for situations where most investors are scared, and that's when you move in to seize quick profits. Warren Buffett offers similar advice to investors hungry for profits: "Be brave when others are afraid." While this system is based on complex technical indicators, it boils down to a simple three-step process:

First, look for a stock with a high put/call ratio (PCR) — the higher the better. This indicates that the stock is oversold and a reversal is imminent.

Second, check to see if the falling stock has a doji, a stock chart signal also known as a profit star. The doji indicates that the stock has hit bottom and is poised for a breakout.

Third, buy the stock, or calls on the stock, and then wait for the herd to rush in on oversold conditions and buy, buy, buy.

Actionpoint Trading

As most people already know, some of the biggest gainers in the market in the late 1990s were the initial public offerings (IPOs). Even though the bear market of 2000 took some of the luster off IPOs, these days, they are coming back into their own. But how does the average investor get in on the fantastic profits that hot IPOs can offer?

There are several extremely effective indicators that you can use to help weed out the weak IPO stocks from the strong, viable ones. We like to zero in on a short list of key ingredients for success:

- **Management** needs to have extensive specific industry related experience, preferably with successful large companies.

- **The board of directors** is dominated by members not affiliated with the company in any other capacity and who provide specific industry-related experience.
- **Strategic niches and marketing channels** are well-defined.
- **Proceeds use** is a key teller of tales. Be sure the proceeds of the stock sales are going to fund company growth.

At their core, profitable IPO stocks are true growth stocks. They are value investments rather than quick in-and-out trades. The most important thing about IPOs is knowing when to take your profits by selling at the right time. Following are several of the most significant signals that are particular to IPOs:

- **Round Trippers:** Buy on the way up, and when you spot the hype cooling, take your profits.
- **Early Management Changes:** One of the surest signs that an IPO company may be in trouble early on is a change in management. Exit and take profits while you can.
- **Sharp and Steady Changes in Cash Position with Slow Operating Results:** This can be a sure sign of coming problems with an IPO company. Watch to see how fast the company spends its funds compared to its operating achievements.
- **Changes in Stated Goals:** What we often see with IPOs that ultimately fail is early and unanticipated changes in the company's goals.
- **Analyst Coverage:** Most IPOs have only one or two analysts following their progress. However, most successful IPOs will begin to pick up additional analysts within the first six to 12 months after going public. Without that added interest, the IPO may be running out of steam.

Profit From the Red Zones

Imagine that there is a hidden stock market, a market within the market, where returns are two to five times greater than the gains you make on your average stock position. This hidden market is the IPO market. By buying and selling shares of relatively new IPOs at specific intervals you can earn double- and triple-digit profits in a relatively short time in what we call the Red Zones.

When a new stock is issued, only a certain percentage of the company's stock is offered to the public for sale. This is known as the "float." The rest, often as much as 90 percent of the shares, is held by underwriters, compa-

Summary: HOT TRADING SECRETS

ny officers, and other insiders. Furthermore, most of that other 10 percent that is issued to the public goes to favorites of the brokerage as a reward for their business. Here are three Red Zones you need to know about to make a lot of money:

Red Zone I: The Widowmaker — The first period after a new issue comes out is usually characterized by massive price swings in the share price. We call these swings widowmaker momentum plays. The inherent price moves are determined by the number of shares issued and the demand level. The underwriters determine the number of shares issued and the supply. And the Wall Street hype determines the demand. Understand this, and you can understand which way the price will move.

Red Zone II: The Share Dump — This is a little secret behind the insiders' manipulations called the *lockup effect*. By contractual obligation, insiders and underwriters can't sell their stock for a period of time, usually between six months and a year from the date of the IPO. This is commonly known as the *lockup period*. But once the lockup ends, anything goes, and insiders may flood the market with shares in an attempt to cash in. In the Share Dump (or the Unlock Zone), the stock starts to drop in price about two months before the lockup period ends. If you know what's going on, you can cash in on this drop.

Red Zone III: The Value Zone — Now we come to the point where all logical investors should want to get in. About 18 to 24 months after the new shares are listed, the stock begins its first real climb. It's now a true value play. Now is the time to step in and buy for a holding period of anywhere from a year to two years or more.

Profiting with the WaveStrength Options Trading System

How about marketwide trends, like the Dow Jones Industrial Average, the Nasdaq, or any of a dozen other market, sector or currency indexes?

An analytical tool known as the WaveStrength method of analysis helps to determine the probability of each move with a reasonable degree of success. WaveStrength analysis is based on the premise that neither underlying value nor news events provide the genuine catalysts for market movements. Rather, short-term price changes are psychological in nature, the predictable result of large numbers of buyers' and sellers' predispositions toward value and news events. WaveStrength translates predic-

Options: A Crash Course

An option is an intangible financial instrument that gives you the right to buy or sell a specific underlying security at a specific price, within a set time period.

One way to translate WaveStrength predictions into options plays is built on the Nasdaq-100 Trust (QQQ:Amex). The Triple-Qs, as they are known, is a basket of the top 100 companies on the Nasdaq lumped together into one instrument that trades like a stock. In Amberger's opinion, the QQQ is the safest and cheapest way to play the trends of the overall market.

Buyers can make large profits from price moves while risking only a relatively small amount of capital. When you buy a QQQ option, you are buying the right to buy or sell 100 shares of the QQQ at a set price within a set period of time. A QQQ option gives you "the right to buy or sell" the QQQ. When you buy the option, you must choose whether you expect to profit from a rise or a fall in the price of the underlying instrument. If you expect the QQQ to rise, you buy a call. If you expect the QQQ to fall, you buy a put.

A call gives the buyer the right (but not the obligation) to buy the underlying security. A put gives the buyer the right (but not the obligation) to sell the underlying security. You can also sell the option itself for a profit or loss.

The problem is, about three-fourths of all options expire worthless, so it is no easy task to consistently make a net profit in options. However, big profits can be made by buying and reselling the options themselves. You need an edge. The key to making this strategy a winner is getting an accurate market forecast and finding the right QQQ option at the right price.

tions made on this premise into options positions on the respective index in question. Options are speculative investments, and their value is as much a slave to supply and demand as anything else.

Here is the WaveStrength secret you need to remember: *Buy an option when nobody wants it, and then resell it when everybody does.* The following five secrets were designed to help you make the most of trading options in today's market:

Secret #1: Value Investing is Becoming Extinct

— In today's market, value investors are getting hit hard for one reason: They are utterly dependent on reported

Summary: HOT TRADING SECRETS

“facts.” And, as we’ve come to know, accountants lie. CEOs lie. Brokers lie. However, index options traders don’t care when accountants lie.

Secret #2: Four Numbers That are Nothing but the Rock-Solid Truth — The only four numbers you can bet your life on are the ones that drive our WaveStrength Trading System. Unlike traditional long-term value investing, index options trading is based on pure facts. The four numbers, simply enough, are the opening price, the high price of the day, the low price of the day, and the price at market’s close.

Secret #3: The Secret of Delta — Options are purposely written in a language very few so-called Wall Street experts understand. Here’s a little tip that will help you swim with the sharks. To understand how your index option will move in relation to the underlying stock, you must understand an option’s delta. You can access an option’s delta using any higher-end tracking service. (We prefer the IVolatility.com Web site, www.ivolatility.com.) Quite simply, the delta represents the change in dollar value of your option as the underlying stock moves up or down \$1.00.

Secret #4: How to Turn Time Decay into a Benefit — Since every option has an expiration date, the clock starts ticking the moment you buy it. Here’s a tip: It’s nearly impossible to make the perfect trade (in other words, buying at the exact low and selling at the exact high). Trying to make the perfect trade every time will cost you more money than you make. This is why WaveStrength adopts the mentality of the professional options trader: quickly take your gains off the table and never look back.

Secret #5: Own the Entire Market for \$150 — When traded correctly, options are safer than stocks and offer more explosive profits. For example, QQQ options allow you to own interests in the top 100 companies on the Nasdaq for about \$150. This is a powerful statement.

A Final Word of Warning

Trading has its own set of risks. You can gain a lot, and you can lose a lot. It’s the nature of the game. Make sure you never lose more than you think you can afford to lose. Even better, never risk more than you can afford to lose. Once you’ve covered your liabilities, shelter, and basic income, set aside a fixed amount of money for trading. Paper trade first. Put your — and our! — ideas to the test. Focus on a strategy that fits your risk tolerance and overall lifestyle. ●

How to Out-Trade the Floor Traders on the Chicago Board Options Exchange (CBOE):

1. You Can Use the Spread to Maximize Your Gains — Options traders simply play what is known as a *spread*, making their money from the difference in the bid price and the ask price. If they don’t trade, they don’t profit.

2. Greed is Their Biggest Weakness and Your Greatest Ally — When using a limit order, always put it as close to the traders’ bid price as possible. That takes away the floor trader’s advantage, and gives you a great entry price on your options play. That’s the secret of the spread.

3. There is One Type of Pit Play Options Traders Fear Most — *Straddles* and *strangles* are descriptive names for two types of options positions that involve buying both a call and a put at the same time. Options traders fear these. And that’s exactly why I trade them. The downside is capped, while the upside is limitless. In this position, you profit if the market goes down, and you profit if it goes up. As long as the market doesn’t trade flat, you profit.

4. Professional Options Traders are the Worst Market Forecasters You’ll Ever Meet — The guys on the floor trade the spread, limit the risk, and hedge against losses. That’s it. So they don’t necessarily have the slightest clue where the market is headed. That’s why you have an advantage.

5. Options Prices Get Soft between 11 A.M. and 1 P.M. — The most intense action in the market happens right when it opens: futures trading. It generally lasts until 10:00 or 10:30 a.m., then calms down, and by about 11:30 prices get soft. This is when most traders take lunch. And while they’re not there to trade, you can get some great options prices.

6. Volatility Dictates Price ... Whether Traders Like It or Not — Options prices move higher or lower at a greater rate than the underlying stock. Options traders are able to move options prices by tinkering with volatility. But they can change prices only so far. If the market is moving against them, there is nothing they can do. If you know how to play the spread between bid and ask, you’re ahead of them.

· Book 22 of 44 ·

Summary



Intelligent M&A

Navigating the Mergers and Acquisitions Minefield

THE SUMMARY IN BRIEF

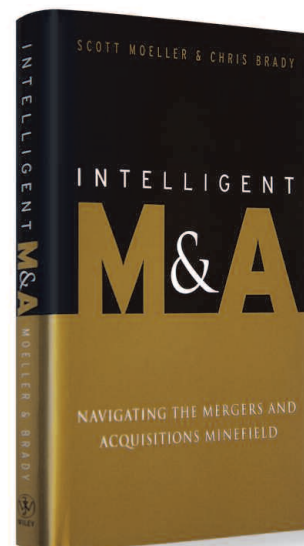
Mergers and acquisitions (M&A) have played a dominant role in shaping and reshaping the global corporate landscape in the last century. If the sheer numbers of deals aren't grabbing headlines, the size and scope of the deals that are made cannot help but command the attention of investors the world over. What is sometimes overlooked in the hoopla, however, is how risky these deals are, and how very few of them wind up working as well as they were originally conceived to work.

To make the best decisions, leaders need detailed and timely information about the commercial and competitive environment surrounding an M&A deal — a function business scholars Scott Moeller and Chris Brady term “business intelligence.” By employing sufficient and first-rate business intelligence as part of the M&A process, companies can manage the financial, cultural and leadership-driven issues inherent to all such deals. This function is a vital aid to managerial decision making in any industry, at any time.

In *Intelligent M&A*, Moeller and Brady set forth a solid strategy for thriving in the high-stakes, high-stress environment of corporate mergers and acquisitions. With a solid theoretical base, as well as real-world focus and application, *Intelligent M&A* is a virtual handbook, showing you how to survive when corporate worlds collide.

IN THIS SUMMARY, YOU WILL LEARN:

- Why business intelligence is so important to the M&A process.
- How to design an effective acquisition and identify the best targets for a deal.
- How to manage the expectations of and interactions with advisors on both sides of an M&A deal.
- How to practice effective due diligence.
- How to successfully integrate the two companies involved in the merger.
- How to survive a merger, including tips on staying visible, informed and invaluable in a time of extreme flux.



by Scott Moeller
and Chris Brady

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THE COMPLETE SUMMARY: INTELLIGENT M&A

by Scott Moeller and Chris Brady

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The Need for Intelligence in Mergers and Acquisitions

M&A are an integral part of the global strategic and financial business landscape, regardless of the role one has. Although fluctuating widely from periods of peaks and troughs of merger activity, the baseline size and growth of mergers is clear. In fact, the “slow” period of activity in 2002 was well in excess of the “peak” activity in the late 1980s.

Yet, despite this impressive trend, mergers and acquisitions are often misunderstood and misrepresented in the press and by those who are engaged in each transaction. Deals — especially when hostile borders, or are among large companies — might be front-page news, yet there is a great deal of conflicting evidence as to whether they are truly successful endeavors. Research has shown an improved performance of companies that make acquisitions.

However, there do seem to be some inviolate truths about M&A deals:

- Many fail to deliver on promised gains to shareholders.
- Boards, CEOs, senior managers and advisors pursue deals for personal reasons.
- Deals have a momentum of their own, which typically means they don't get dropped when they no longer make sense.
- The deal doesn't end when the money changes hands. Rather, this point marks the start of the most difficult stage of the deal — the tough integration process that few get right.
- Success with one deal doesn't guarantee success in the next deal.

Different Types of Mergers and Acquisitions

The three major types of mergers/acquisitions are driven by different goals at the outset and raise different

issues for the use of business intelligence:

- **Horizontal mergers** are mergers among competitors or those in the same industry operating before the merger at the same points in the production and sales process. For example, the deal between two automotive giants, Chrysler in the U.S. and Daimler in Germany, was a horizontal merger.

- **Vertical mergers** are deals between buyers and sellers, or a combination of firms that operate at different stages of the same industry. There is often less common knowledge between the two companies in a vertical deal, though there may still be some small degree of common clients and suppliers, plus some previously shared employee movement.

- **Conglomerate mergers** are between unrelated companies, not competitors, and without a buyer/seller relationship (think of General Foods and Philip Morris' merger in 1985). Conglomerate mergers do not have a strategic rationalization (like cost savings) as a driver, but do typically manage to feature creative uses of business intelligence.

Deals are either complementary or supplementary. A complementary acquisition helps to compensate for some weakness of the acquiring firm. A supplementary deal is one where the target reinforces an existing strength of the acquiring firm; therefore, the target is similar to the acquirer. ●

Business Intelligence

By failing to coordinate and prioritize the business intelligence function, companies increase the risk of failure in any endeavor but perhaps most significantly in the M&A arena. Intelligence failures generally occur, despite the wealth of information available, because of a lack of a systemic intelligence function and consequently a lack of suitable analysis for decision makers to draw upon. In business



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Rebecca S. Clement, Publisher; Sarah T. Dayton, Editor In Chief; Melissa Ward, Managing Editor; Christine Wright, Senior Graphic Designer; Rob Smith, Contributing Editor

there is no such thing as a pleasant surprise; any surprise is worrying because it indicates weak intelligence systems.

Intelligence should be at the very heart of all corporate endeavors but often is not. A recent global work force research study shows that less than half of employees believe that they are in safe hands and that their executives are taking steps to ensure the long-term success of their organizations. How, then, should organizations avoid catastrophes? The answer is by staying in close touch with the external environment.

Business Intelligence Industry

Whether traditional or modern, the intelligence function remains the same — to be the eyes and ears of the organization, to gather and analyze information that provides a competitive advantage. Why, then, does it appear so difficult for organizations to engage with the external environment?

First, as most observers agree, there is a perception of greater complexity in the modern business environment. Getting to the other side of that complexity clearly involves greater knowledge of the environment but also greater knowledge of how to deal with complexity.

The second reason why organizations fail to engage with the environment is that they do not believe it is necessary. They become complacent. They believe that their approach has worked, is working, and will, therefore, continue to work. They fail even to observe it, much less respond to it.

Finally, and perhaps most significantly, organizations simply fail to give sufficient thought and resources to intelligence as a function. Unwise leaders often choose to limit the effectiveness of the intelligence function by affording it too little value and, consequently, too few resources. How does one best engage with the external environment? By creating an organizational intelligence system.

Review

The first component in such a system is a review of the components of the company's external interaction, in a facilitated brainstorming session. Identify any gaps in the external provision, any disconnections between the components. The review process need not be complicated or expensive, but it will be resource intensive, and the resource will be the brainpower and thinking time of the senior management team, and not just for the day of the brainstorming.

Structure

Having identified the gaps or inefficiencies in the company's established intelligence system, remedies must be implemented. It may be that internally advertising one's product range can actually stimulate recognition of the value of those products and change the culture. Essentially there are seven intelligence products that a

mature intelligence function can provide:

- **Immediate intelligence.** Intelligence collected from open sources to provide endusers with intelligence within a 24-hour time frame.
- **Continuing intelligence.** Intelligence that is rigorously researched, analyzed and documented, delivered by continuous monitoring of the competitive environment.
- **Technical intelligence.** Intelligence that maintains technological competitiveness and manages R&D and new product development projects effectively, evolving in approach according to evolving technologies.
- **Analytical intelligence.** Intelligence that provides advanced warning of emerging opportunities and/or threats.
- **Internal intelligence consulting.** Intelligence gleaned by embedding analysts within internal M&A teams, enabling the analyst to provide targeted and timely intelligence to the group.
- **Activated intelligence.** Intelligence requests generated by both formal and informal observation of the environment, appearing at the request of a client and tailored to that client's needs.
- **Counterintelligence.** Intelligence activities undertaken to protect the company from other entities looking to exploit the company's vulnerabilities. ●

Designing the Acquisition Process

Although each acquisition or merger deal is unique, in general the merger process usually unfolds in six stages:

1. **Corporate strategy development:** determine if acquisition or merger is the appropriate strategic move; develop a long list of possible candidates.
2. **Organize for the merger/acquisition:** select project leader, form different teams, identify outside advisors, and so forth.
3. **Specific deal pricing and negotiation:** includes identification of final acquisition candidate(s), valuation and pricing, and negotiations between both managements.
4. **Structuring and approval:** engage in tasks including structuring the deal, conducting due diligence, arranging financing, ensuring approval by common stockholders, filing appropriate paper and closing the deal.
5. **Post-merger integration.**
6. **Post-acquisition review.**

The buyer's perspective differs from the seller's but both largely need to follow these steps. Although it is more common for buyers to initiate a deal, targets can also put themselves up for sale. Sellers initiate deals most

Summary: INTELLIGENT M&A

commonly when they are experiencing some difficulty, including financial difficulties, succession issues or legal matters. It is critical to determine the underlying reasons because they are not always stated.

From the seller's perspective a typical takeover proceeds through the following stages:

1. Corporate strategy development to determine if the division or company should be sold.
2. Preparation of the expected pricing and expected deal terms.
3. Organization for the merger/acquisition: select project leader, form different teams, identify outside advisors, and so on.
4. Development of a "long list" of possible buyers and discussions with those companies.
5. A "short list" stage with limited due diligence completed within the seller's company.
6. A "preferred bidder" stage with almost unlimited due diligence and strict confidentiality agreements exchanged.
7. Deal finalization: arrange financing, approval by common stockholders, file papers and obtain approvals with jurisdictions in which each company operates, and closing. ●

For additional information on design of the acquisition process, go to <http://my.summary.com>.

Controlling the Advisors

Although the ultimate responsibility for the success of a deal will rest with the board of directors and senior management, in most mergers there is a large number of advisors necessary to bring the deal to completion. Some of these advisors may be involved from the first step in the planning process through to closing, whereas other advisors will play a much more limited role during a very specific part of the merger process.

Advisor Roles

There are numerous advisors involved in a merger or acquisition, among them the following:

- The **financial advisor** is typically at the center and acts as the experienced coordinator of many of the other advisors and their activities. The financial advisor not only gives general financial advice but also drafts some and coordinates all documentation, controls other advisors (and often the client), advises on target valuation and deal pricing, manages the overall strategic direction of the offer and lends his or her reputation to the transaction.
- **Solicitors and lawyers** will draft legal agreements

and documents and the "back end" (details) of offer and defense documents. They give general corporate and regulatory advice and sometimes offer tax advice.

- **Accountants** draft the "middle bit" (numbers) of the offer documentation and provide the "independent" financial information as required. Note that it is management, not the accountants, that produces the financial forecasts.

- **Human resources consultancies** help bidders determine the strength of the target's senior and even middle management teams. The bidder needs to know as well whether those people will stay with the new company and what incentives will be required.

- **Stockbrokers** are the principal line of communication with institutional shareholders and because of their knowledge of the markets and the investors, they provide input on valuation and pricing.

- **Public relations advisors** help with the selling message to multiple audiences, including not only the shareholders who will ultimately determine whether the deal is acceptable but also to management and staff of both companies, customers, suppliers and the general public.

Advisors and Business Intelligence

Each of the advisors can play an important intelligence role, although often each advisor's actual role is limited to his or her traditional functions. Accountants, for example, check and produce the numbers, but, if asked, can provide important information about the industry and other companies in the market.

Both large global consultants and small boutique advisors are renowned for their ability to seek out nonpublic information about clients and customers. Often, it is difficult for a company to ask this information directly because it would need to identify who is asking. Consultants, on the other hand, do not need to disclose their clients unless asked — and frequently are just not asked!

Do not forget to employ your intelligence function on your advisors. No matter how reputable the advisors or how much work in the deal is conducted by the external consultants, the board, senior managers and employees are the ones who will live with the result for years. This responsibility cannot be delegated. ●

Identifying the Best Targets

The reasons for carrying out M&A activity are dependent on the context of the business, the dynamics of the environment, future strategic intents and the personal motivations of senior management. These motivations will define the approach taken to acquisition planning; each company must make its corporate development

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strategy explicitly and directly based on these motivations. In this way, these companies will have clear working guidelines spanning different time periods that address their strategic intent, where they would wish to expand, and even where they would like to divest. This strategy must be both realistic and personalized to the company. It will identify where there are holes that must be filled with acquisitions or mergers.

The Role of Strategy

In reference to finding a possible target, management can make quick, informed decisions based on their knowledge of their own capabilities, corporate strategy, the state of the market, an understanding of the business of the target and current key stakeholder perceptions. From this point they choose whether to act on the opportunity or to attempt to buy more time in order to carry out some more research on key determinants.

M&A deals are by definition a means to an end. They should never (but sometimes do) drive strategic situations and choices. Whatever the business strategies that a company employs to its competitive advantage, the establishment of acquisition objectives should be firmly rooted within an entity's "grand design," helping to promote its strategic goals and objectives.

Screening Candidate Targets

The screening of candidates will typically include the following criteria, but the actual criteria used may differ for each acquirer and even for each deal:

- Industry and the target's position in it
- Size of the business (sales, assets, market value, etc.)
- Strategic capabilities

Cisco Picks Its Targets Well

Cisco, like some serial acquirers, has become quite adept at ascertaining that companies they acquire fit their corporate strategy; the company relies on acquisitions to complement its own internal research and development. Cisco has had periods when it buys one to two companies per month. In its early period of rapid growth, it developed a six-point blueprint for evaluation of prospective acquisitions:

1. Similar vision to Cisco
2. Must produce quick wins
3. Long-term win situation for all parties (shareholders, employees, customers, partners)
4. Cultural compatibility must exist
5. Close geographic proximity to Cisco
6. Friendly deals, never hostile.

- Profitability and other financial factors
- Risk exposure, including the cyclical nature of the business, any significant legal or regulatory issues, inherent risks to the products, etc.
- Asset type, whether buying the whole company or just a division, real estate, natural resources or people
- Intellectual property: patents, client lists, supplier relationships
- Management quality and the likelihood that they will remain with the company
- Current ownership
- Cultural and organizational fit. ●

For additional information on screening candidate targets, go to <http://my.summary.com>.

Due Diligence

In M&A, the due diligence process includes the verification of material facts and an examination of the external relationships of the company and the internal finances, operations and management. While due diligence is often seen as the bidder's responsibility, it is just as important for the target to conduct due diligence on the bidder in order to determine whether the offer is bona fide and legitimate and, most importantly, to ascertain whether the bidder has the financial capacity to complete the transaction.

The Due Diligence Process

The key factors in conducting informative and timely due diligence are the following:

- Identifying the most important items to collect: in most deals there is not enough time to look at everything in as much detail as desired.
- Identifying the right sources for the desired information within the required time frame.
- Identifying the right people to review the data: this should naturally include the people who know most about that area and should also include people who are expected to be managing the business post-acquisition and therefore will use that information.

The target company is not required to provide to a bidder (or vice versa) any confidential or nonpublic information unless in a situation where compelled by the courts. The target is also not required to disclose information to any party that the party has not requested. Of course, withholding information is not necessarily recommended, especially if it is necessary to keep the deal friendly and to get a higher price.

Types of Due Diligence Information

Due diligence can be divided into external and internal information. External due diligence should, if possible, be conducted before the deal is underway when the time pressures may not be as extreme as the period after the deal is announced. Internal due diligence is conducted throughout the deal. Both need to be continually updated as conditions change. In addition, each industry will have its own special due diligence requirements.

While due diligence does enable prospective acquirers to look for potential “black holes,” the aim of due diligence should be this and more. A well-managed due diligence assignment — varied in each specific case by scope and scale to reflect the unique issues of each deal — will help firms to improve their financial performance, strengthen their competitive positioning, develop internal “know-how” and be better able to grow through M&A.

Business intelligence is at the heart of due diligence, providing company executives with the kind of insight that enables them to make appropriate commercial decisions and plan for the future. While 90 percent or more of information required for merger or acquisition activity is widely available, the key skill in this entire process is the ability to identify what information is needed, where it is most likely to be found and then determine a way to extract that information.

Financial Due Diligence

Often the mainstay of the M&A process, financial due diligence enables companies to obtain a view of an organization’s underlying historical profits, which can then be used as a canvas on which to paint a picture of the company’s financial future. A prospective target’s financial

statements may enable acquirers to identify reasons why a company wishes to merge or sell out.

The building blocks for such information include auditing and verifying financial results on which an offer is based, identifying deal breakers, providing ammunition for negotiators and pinpointing areas where warranties or indemnities may be needed, and providing confidence in the underlying performance (and therefore future profits) of a corporation.

Management Due Diligence

It has become common practice for acquirers to perform discreet investigations in order to evaluate the competence of the target’s management and quality of their past performances. Since often it will be management who will be carrying the merger forward, it is crucial that adequate time is spent on making sure the best people are in place with all the support they might need. ●

Post-Merger Integration

An M&A deal does not end with the completion of the transaction at closing. In most cases, the closing of the deal is only the start of the truly hard work of making the newly formed company work.

Post-merger integration is the “quiet” phase of the typical merger; to the outside world there is usually very little discussion about the deal in this phase unless, of course, it is falling apart and was a high-profile deal. The success of the deal actually depends more upon the post-merger integration than any other single step in the M&A process.

In fact, a merger will likely fail if it has the right strategic rationale but poor implementation. Likewise, failure will follow a merger carried out at the best price but with bad post-merger integration. On the other hand, if a deal has no sound strategic rationale or if the strategy was based on circumstances that have now changed, and even if the deal was done for too high a price, the newly combined firm can still be successful if there is effective and creative management of the new organization after the merger. The simplest way to work toward success is to focus on post-merger integration.

Change Management and Integration Costs

Post-merger planning should reflect the desired change from the deal. If the strategy behind the deal is unclear, there is no reason to expect successful post-merger integration. Different types of acquisitions bring with them different post-merger problems.

The costs of doing integration poorly can be immense. The overall cost includes not only out-of-pocket, quan-

Oracle’s Management Lists

In the lead-up to an acquisition in early 2006, Oracle was given the names of 53 key people that could not be poached during the merger discussions or afterward for a period in case the deal fell through. If one is given such a list, as noted by the Senior HR Director for Europe, the acquirer has the beginnings of a tool to check with customers and former employees as much as it can about those 53 people, as they are presumably the best of the best in that target company. This process can identify possible problems and issues with those individuals and with the organization.

In addition, it turns something meant to be defensive on the part of the target into something of even greater value to the bidder in the due diligence process.

tifiable expenditures (rebranding, systems integration and the like), but also items that are difficult to quantify but that will have a major impact on the newly merged company's bottom line, including the following:

- Hiring and training employees in new positions
- Time-consuming and distracting meetings and activities during integration
- Dysfunctional politicking and power fights
- Decrease in employee efficiency during the period of uncertainty
- Customer confusion and competitors' attempts to poach clients during this period.

Integration Planning

Integration planning should begin at the deal idea-generation stage and continue throughout the merger process. There are five major stages in the post-merger integration process:

- 1. High-level merger planning:** discussion at the senior executive level, including talks about how the companies can or will combine.
- 2. Formal (or leaked) announcement:** Employees and management will have mixed emotions, and expectations rise in many cases due to the external discussion about the deal's potential. Due to the natural uncertainty by most about the deal, it is important to be able to announce some integration plans at the same time or within days of the deal announcement.
- 3. Initial organizational merger planning:** The organization is unstable and although many employees have the best intentions to cooperate, good will quickly erodes. Post-merger planning is now out in the open with a need for effective use of business intelligence.
- 4. Initial post-deal integration:** often intense during this period (typically 100 days) but with a high level of organizational instability, including "us-them" mentality and intra- and interdepartmental hostility.
- 5. Psychological integration:** Roles and systems are by this point clarified, and there are successes demonstrating the power of the new organization; this is a long-term, gradual process, which may take years to finalize.

Keys to Integration Success

In order to achieve a successful post-merger integration — and thus the success of the deal — there are eight areas that require attention:

Leadership. It is important to set up the appropriate structure and organization for the post-merger integration, starting with the leadership. The top of the company needs to be seen internally and externally as being

focused on the success of the deal and on managers and employees internally.

The CEO must appoint an integration manager who comes from a high level in the organization, ensures middle management buy-in and involvement through the use of integration planning committees and task forces and makes quick decisions on compensation where necessary. A single integration manager must also be appointed to speed up the integration process, create a structure, forge social connections between the two organizations and help engineer short-term successes.

Engineer successes. One way to maintain the client base and even to grow it is through the engineering of successes, even if these are not "real." This can be used to demonstrate the power of the new organization and should be done as soon as possible after the deal is announced (and planned well before that time.) These wins, when communicated properly, can be an effective morale booster internally as well.

Act quickly. When talking to almost anyone involved in a successful integration, the need for speed is usually mentioned in the first sentence. It is critically important to make the key decisions very quickly. Uncertainty is the virus of successful post-merger integration, as this will lead to customers, managers and employees leaving.

Retain key employees. It is also important to retain key employees in both the acquiring and acquired companies. Each employee will be most concerned about "me." If those concerns are not addressed, no other business will get done properly as managers and employees will be distracted. The intelligence function should help the acquirer identify key personnel.

People-related issues typically represent much of the hidden post-merger integration cost to the new organization. Organizations that anticipate these issues will be best positioned to deal with them effectively and to minimize the negative financial impact they represent.

Nurture clients. Do not lose sight of the revenue side of the business — the focus on clients. While the company is worrying about integration, the outside world will not be so distracted: Customers can be poached if not nurtured and suppliers are at risk. It is therefore important to encourage the sales force and relationship managers to be alert to signs that there are problems.

Communicate. Communication must emanate from the very top of both organizations or else they run the risk of lacking credibility. Managers must "walk the talk" and show that they have recognized the changes to the organization and their impact on individual employees. The very senior managers can best communicate the vision of the deal and the related business logic.

Summary: INTELLIGENT M&A

Communications must demonstrate transparency and openness at all times; a lack of candor or honesty will be immediately sensed by most employees, and the good will that is critical to have in place for the successful implementation of the deal will be destroyed.

Integrate the two cultures. Cultural integration is paramount in the post-merger period. It is important to make the social connections in terms of communication, identification of common core values and recognition of the importance of “superficial” issues such as titles and company and division names. It is an issue not just for senior managers but for all levels of the organization, as both companies will have had unique cultures that may not instantly or naturally mesh.

Adjust, plan and monitor. Managers should prepare for surprises — these will always occur in a situation as complex as merging two companies and their employees. Nothing should be cast in stone — be willing to make changes, anticipate unexpected external events and manage them as best as possible.

Planning should start at the beginning of the deal idea stage. This includes an identification of whom will fill key roles, their responsibilities, and mapping out what the future organization will look like. Business intelligence can be used to determine what changes will be necessary. ●

How to Survive a Merger

In today’s business environment, it is unusual for an individual not to experience a merger or acquisition at some point during his or her career. It is certainly useful to know about survival techniques and tips that have proven helpful to others when faced with an upcoming or ongoing merger.

Survival Tips

Assuming you wish to stay with the newly merged company, what should you do? The techniques of good business intelligence applied to your own personal situation would include the following:

- **Start to prepare during the pre-merger phase.** Be part of the merger planning and design process, and/or the post-merger integration team. Get to know the other organization as well as possible using internal and external contacts and resources. This will not only give you information that will be personally useful but also will enable you to be considered more valuable, particularly if you understand the other company better than your colleagues do.

- **Don’t think that your boss will take care of you.** As with everyone else in the organization, your boss will be looking out for him/herself first. He or she may even have less of an idea than you do as to how decisions will be made.

- **Stay around the office.** Become more visible. Be the hardest worker, or at least perceived to be such. This will demonstrate that you are invaluable and provide you with opportunities to pull out all the stops and produce.

- **Your own team may be your most valuable asset.** Your own team may have sources of information that aren’t communicated by your network or by your manager. Additionally, you’ll feel better if you are doing your best for your staff. Furthermore, you may need them in the new organization and you don’t want them to consider leaving prematurely.

- **Network incessantly, both internally and externally.** This is important both to gather intelligence about what is to happen and to gain support as decisions are made. Also, let others know your accomplishments, talents and what you’ve done for the company.

- **Keep your clients and keep them happy.** You can avoid being made redundant by making sure your clients are loyal to you personally as the salesperson, and not necessarily to the newly merged company. Support and middle-office staff should think of the front office as their client. Try to link yourself with some client-facing teams; at least get those who you support to speak up positively on your behalf.

- **Be flexible.** Be willing to move or change jobs, and to show adaptability to a new corporate culture, manager, travel, job requirements, hours and other business practices.

- **Prepare for the worst, even if you think your job is secure.** When rumors about a merger or acquisition appear, take them seriously. Such preparation is especially important if your company is the smaller one in an acquisition.

- **Be positive about the new company.** Be future oriented and focus on the needs of the new organization. A positive outlook about yourself and your place in the company can be important in easing your anxieties about work and the merger.

There are no guarantees that a job can be retained or found in the newly combined company, but an application of these recommendations should improve the odds immensely. ●

RECOMMENDED READING LIST

If you liked *Intelligent M&A*, you’ll also like:

1. ***Making Strategy Work* by Lawrence G. Hrebiniak.** Hrebiniak offers a comprehensive, disciplined process model for making strategy work in the real world, where formulation and execution are both major challenges.
2. ***The Well-Timed Strategy* by Peter Navarro.** Navarro provides the tools to align every facet of business strategy, tactics and operations to reflect changing business conditions.
3. ***Corporate Agility* by Charles E. Grantham, James P. Ware and Cory Williamson.** In order to compete in the flat world, businesses must be willing to embrace a new strategic model. *Corporate Agility* provides the blueprint for this revolutionary move forward.

· Book 23 of 44 ·

Summary



Higher Returns with Lower Costs —
Do It Yourself Strategies Without Paying
Fund Managers

Investing With Exchange-Traded Funds Made Easy

THE SUMMARY IN BRIEF

Exchange-traded funds (ETFs) offer exceptionally low expenses, outstanding performance and unparalleled transparency. They are one of the fastest growing investments in the United States, and the number and variety of choices can be overwhelming. Dr. Marvin Appel explains exactly how ETFs work, what they can and cannot do, and why they are not all equally attractive. Using objective data and proven, back-tested strategies, he shows how to quickly move into the right ETFs at the right time, consistently staying on the winning side of major market trends.

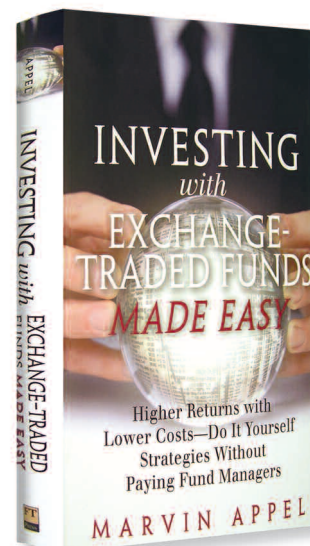
Several facets of ETF investing are discussed, including quantifying potential risk and reward, using ETFs to improve diversification, implementing simple “active strategies,” deciding when to move into cash and more.

ETFs are a powerful investment tool, but it's important to understand how they work and what makes them different from other mutual funds. ETFs offer exposure to all the major investment styles and also offer the ability to move assets from one style to another to increase investment performance.

Appel provides a candid assessment of the risks, costs and rewards, creating a start-to-finish plan for becoming an informed and effective ETF investor.

IN THIS SUMMARY, YOU WILL LEARN:

- The big difference between ETFs and regular mutual funds.
- The truth about ETF costs, risks and opportunities.
- How to build your “one-decision” portfolio.
- Drive greater profits with simple asset allocation strategies.
- Choose ETFs that match your investment style.



by Marvin Appel

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THE COMPLETE SUMMARY: INVESTING WITH-EXCHANGE TRADED FUNDS MADE EASY

by Marvin Appel

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Now Individuals Can Invest Like the Big Players

ETFs are a powerful investment tool. However, before you use them, you should understand how they work and what makes them different from mutual funds.

ETFs are a special type of mutual fund. ETFs hold a basket of individual stocks, just as mutual funds do. Each ETF share represents a proportional piece of the portfolio of stocks, as with mutual funds. Therefore, many of the advantages of mutual funds also characterize ETFs:

- Ability to diversify with a single investment
- Ability to gain exposure to a particular investment style (small versus large company stocks, for example) or to a specific industry (utilities, technology, etc.) with a single investment without having to select individual companies

ETFs Avoid the Expense of Fund Managers

Most mutual funds have managers who pick which stocks to buy and sell, and when, according to their own judgments. In contrast, ETFs are passively managed, meaning that a predetermined set of rules is used to select the individual stocks that are held in each ETF. An ETF sponsor can update the selection of stocks in a passively managed portfolio but only on dates that it specified in advance. Because the rules for selecting a passively managed portfolio are available to everyone, it is unnecessary to hire a manager.

The fund sponsor for each passively managed ETF selects a set of rules that govern which stocks the ETF will hold. After these rules are in place, the ETF does not deviate. Investors in a passively managed fund or ETF know at any time exactly which stocks are in the fund

and when that portfolio is scheduled to change. The accurate knowledge by individual fund investors of their funds' holdings is called *investment transparency*. Investment transparency is considered an advantage because when you buy an ETF, you know exactly what you are getting.

Another term used to describe passive investment management is indexing. The connotation of a market index, in addition to being passively managed and enjoying the same advantages of low cost and transparency, is that it usually aims to represent the performance of a particular market sector. Broadly based indexes can represent the entire universe of publicly traded shares in the United States, or even the world, or at the other end of the spectrum, a particular market sector.

ETFs Are Traded on Exchanges

The big difference between ETFs and regular mutual funds is that as an individual investor, you buy ETFs on a stock exchange. You do not deal directly with the sponsoring mutual fund company, and you bear the full costs of every transaction you make. With a purchase of an ETF, you must pay a broker's commission, similar to the charge you would incur to buy an individual stock. Whether this is an advantage to you depends on how you are using ETFs.

Unlike mutual funds, which need to create new shares to meet your purchases and to eliminate existing shares to meet your redemptions, when you buy or sell ETF shares, you conduct the transaction with another investor. You and the other investor exchange ETF shares for cash, but the number of outstanding ETF shares does not change as a result of your transaction; only the list of shareholders changes.

Every transaction in an open-end mutual fund for the entire day receives the same price. An order placed with



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Rebecca S. Clement, Publisher; Sarah T. Dayton, Editor In Chief; Athena Nicolaides, Art and Design; Linda Shekhdar, Contributing Editor

Summary: INVESTING WITH-EXCHANGE TRADED FUNDS MADE EASY

a fund at 9 a.m. gets the same closing price for the day as one placed at 3:59 p.m. That closing price is set based on data from the market close at 4 p.m. Any order received at a mutual fund after 4 p.m. receives the next day's closing price.

Any trading model that utilizes daily data from the market close is likely to perform more poorly if trades are not executed on that same day. Investors who use mutual funds that allow unlimited trading must submit their buy or sell orders to the mutual fund before the market closes. There is a chance that some trading decisions made before the close will turn out to be different from the decisions that would have been made if the final closing data had been known earlier.

This means that for investors who utilize end-of-day trading strategies, ETFs have a big advantage that does not apply to individual stocks or mutual funds. Many ETFs trade until 4:15 p.m., 15 minutes after the regular market closes at 4 p.m. This allows you to wait until the market closes to collect data and then use that data to decide which trades to execute on the same day.

ETF Investors Have Hidden Costs Through the Bid-Ask Spread

The price you pay for your ETF depends on the balance of supply and demand for that ETF at the time your order hits the trading floor. An ETF's share price is usually slightly different from the market value of the fund's underlying holdings. Moreover, the price a buyer pays is generally higher than the price a seller receives.

The price you pay to buy shares is called the asking price or *ask*. The price you receive when you sell shares is the *bid*. The bid-ask spread is no less a cost to you than a broker's commission, despite being less visible. But to the unwary investor, the bid-ask spread is a hidden cost. Before you decide to buy an ETF, you should ask your broker for both the bid and ask so that you can get a feel for the cost per trade.

The Creation/Redemption Process Keeps ETF Share Prices Close to the Market Value of the Underlying Shares

Each ETF has a custodian who holds the shares. However, rather than keeping track of which shares belong to which individual investor, all the custodian has to do is make sure that the number of ETF shares in circulation is exactly the right amount for the custodian's holdings of underlying shares. In this regard, an ETF share (in the hands of an authorized participant) is like a

claim check. Whoever submits the claim check can retrieve the stored item, which in this case is a basket of stocks. Because all investors know what goods the claim check represents, they can trade claim checks among themselves without needing to inspect the underlying merchandise for each transaction, while the custodian simply guards the merchandise until someone claims it.

Even though ETF shares are traded between investors far more frequently than they are exchanged for the underlying basket of stocks, authorized participants do have the option of switching between ETFs and the actual underlying shares in individual companies. If an authorized participant wants to create shares of an ETF, it can deliver the basket of stocks to the ETF custodian. Conversely, if the authorized participant wants to redeem shares of an ETF, it can deliver the ETF shares to the custodian, who transfers the underlying stocks' shares in exchange. Creation or redemption of ETFs usually occurs in lots of 50,000 ETF shares.

The ability of authorized participants to create or redeem ETF shares in exchange for the underlying stocks gives them a financial incentive to keep the price of ETFs close to the market value of the underlying shares.

The process of simultaneously buying and selling essentially identical baskets of stocks in different places at the same time to profit from price discrepancies is called *arbitrage*. Firms that practice arbitrage help maintain a narrow gap between the ETF's market price and the value of its underlying shares.

The market provides two types of information throughout the trading day for you to consult when you are considering making a trade: the current bid and ask prices and the Indicative Optimized Portfolio Value (IOPV). IOPV is the fair market value of the underlying basket of stocks in the ETF. This is updated every 15 seconds.

ETF Performance Is Not Weighed Down by Transaction Costs

The only way for ETF shares to be redeemed is with a transfer of shares of individual stocks. No cost is involved in simply transferring stocks from one account to another, so the performance for remaining ETF shareholders is not adversely affected when ETF shares are redeemed. Those costs fall entirely on the authorized participant firms if they elect to liquidate shares they have received from a creation or redemption.

ETF Shares Are Often More Tax-Efficient Than Mutual Funds

The exchange of ETF shares for shares of stock avoids realizing capital gains when many shareholders want to unload the fund. This is because the exchange of ETF shares for shares of the underlying stocks does not create a taxable event. The only way for a long-term shareholder of an ETF to realize capital gains without selling his own shares is when a change in the basket of stocks forces the sale of some shares. Because all ETFs that are currently trading in the United States are passively managed and therefore have low portfolio turnover, the risk of a large capital gains distribution is minimal.

In contrast, in a regular mutual fund, when shareholder redemptions force the fund to sell stock holdings to raise the cash needed to meet those redemptions, any profits on the stock sale generate capital gains that are passed on to the remaining shareholders of the fund at the time of its annual capital gains distribution. This means that long-term shareholders might have to pay capital gains taxes because some other shareholders sold out.

Special Risks of ETFs

ETF share prices are sensitive to the balance between supply and demand — a risk absent from regular mutual funds. ETF investors face the additional risk of relying on authorized participants to keep ETF prices in line with the underlying share values. During *fast markets* — periods marked by an overwhelming imbalance between supply and demand — authorized participant firms and specialists have been known to be slow to step up and fill the wave of orders. The result is that at the time you are most anxious to sell, you might not be able to get as fair a price (relative to the value of the underlying shares) as you thought you would. Also, if you buy or sell during a fast market, your bid-ask spread costs will be higher than normal. ●

A Guide to Different Investment Styles

The first decision that the individual investor must make is how much to invest in each area. The optimal asset allocation in general will be different at different points in the life of an investor and will depend on the economic outlook.

Even though stocks have been significantly more profitable over the years, the fact that bonds have had less than half the risk of stocks and have outperformed stocks almost one-third of the time suggests that all but the

most aggressive investors should maintain some exposure to bonds in addition to stocks to improve their balance of risk versus reward.

The main functions of cash in an investment portfolio are to provide a source of consistently positive performance and to reduce volatility. Conservative investors can use a cash position to reduce the risk of having a losing year.

Size Matters

The first distinction between different stocks is the size of the company. From an investment perspective, company size is measured as the dollar value of all outstanding shares. While no universally accepted range of market capitalizations defines large-, mid- and small-cap stocks, generally these dollar amounts are a “soft” guideline:

- Large-cap stocks generally have market capitalizations over \$10 billion, such as WalMart and Exxon Mobil.
- Small-cap stocks are generally considered to have total market capitalization of less than \$2 billion.
- Midcap stocks have market caps ranging from \$2 - \$10 billion. As an investment style, midcaps have had the best performance in the past 25 years compared to large- or small-caps.

The distinction between different market capitalizations is relevant to the individual investor. Academic research has suggested and experience has demonstrated that market capitalization is an independent predictor of investment performance. The success of a small- or large-cap investment can depend critically on *when* you make it. A successful strategy that allocates investments to large versus small stocks might by itself significantly increase investment performance. Active investors who trade often will discover that the cost of trading ETFs that hold small-cap stocks is significantly greater than the cost of trading large-cap ETFs.

A new category of ETF was launched in August 2005 to represent the behavior of microcap stocks, which are the smallest of the small-caps. The underlying microcap index represents the broad universe of microcap stocks listed on national exchanges.

Microcap ETFs must overcome two inherent difficulties: The underlying individual stocks are difficult to trade, which in finance is called *poor liquidity*, and the sheer number of microcap stocks that are available.

All-cap or total-market ETFs can be useful proxies for the overall stock market. There are four ETFs that capture the behavior of almost the entire market capitalization of the United States: the iShares Russell 3000 Index Fund (IWM), the Total Market Vipers (VTI), the

Summary: INVESTING WITH-EXCHANGE TRADED FUNDS MADE EASY

StreetTracks Total Market ETF (TMW) and the iShares Dow Jones Total Market Index Fund (IYY).

Growth and Value ETFs

Other criteria are available with which to segregate groups of stocks besides market capitalization:

- *Value indexes* represent the collective behavior of stocks that appear cheap compared to the overall market in terms of their current earnings, dividends or value of the company's underlying assets.
- *Growth indexes* represent stocks that generally appear expensive relative to the overall market in terms of their current earnings, dividends or book values but are attractive to investors because they appear to have better future prospects.
- *Blend indexes* do not attempt to separate growth and value stocks. ●

A One-Step Strategy for Selecting Superior Investments: Indexing

It is important to understand how to make investments that perform like market indexes, because for most investment styles, such investments have outperformed the majority of actively managed mutual funds.

Market indexes define a stock market index as just the average price of a group of stocks. The selection of stocks in an index and the contribution each stock makes to the overall index are specified by objective rules that the public knows in advance.

Indexes typically represent the behavior of specific groups of stocks, the entire U.S. market, a cross section of the U.S. economy, small publicly traded U.S. stocks, large U.S. stocks, etc. Some indexes represent specific industry sectors such as semiconductors, gold mining companies, oil companies, for example.

The list of stocks that comprise an index and their weights in the index are determined at infrequent intervals by the index sponsor and then are distributed to the public. As a result, an index fund does not need a manager to pick stocks. The trader just has to make sure that the fund or ETF portfolio contains the right stocks in the right proportions.

The performance of an index fund is by definition average, but it saves the considerable cost of a manager, giving its performance net of expenses a head start compared to the average mutual fund. ●

Investment Risk: A Visit to the Dark Side

You cannot evaluate the merits of an investment until you have a thorough understanding of both its potential risk and return. Committing your money before obtaining such an understanding is like buying a house without first conducting an inspection.

A handy concept in describing risk is *drawdown*. Drawdown is the largest investment loss sustained in the past, from a high point to a low point in investment capital. However, be alert to the period over which you measure a drawdown.

Bottom line: You need to measure drawdown during the worst market climate for each investment you are evaluating: 1973-1974, 1987 and 2000-2002 for large-company stocks; 1998 for small-company stocks; and 1998-1999 for value stocks. The larger the historical drawdown during its worst period, the riskier you assess the investment to be.

If a fund or ETF did not exist during the period that would be most informative to you, find a comparable investment that has a sufficiently long history and use that as a surrogate with which to measure risk.

Each major investment objective has one or more benchmarks. For example, the Dow Jones Industrial Average consists of 30 large U.S. company stocks; therefore, it is a benchmark for large-caps. The NASDAQ Composite is most heavily weighted in technology stocks so it is a technology stock benchmark.

When you have identified a benchmark for your fund, use charting software or Internet resources to plot the benchmark and the fund for the period when they were both actively trading. If they have experienced major dips and rallies of similar extents at the same times, it is reasonable to attempt to use the longer history of the benchmark to help you understand your fund.

Risk Assessment of an Emerging Market ETF

A longer-term look at stock markets in developing countries indicates that the emerging-market fund average has suffered four major declines between 1989 and 2005. The duration of these drawdowns ranged from 28 to 47 months. The question of how well the past performance of emerging-market stocks reflects their future potential has no clear answer; it is a matter of subjective judgment. Even though profit potential for emerging markets appears to be bright, you cannot assume that risk will be lower in the future. ●

Risk-Adjusted Performance

It is crucial that an investor understand the concept of risk-adjusted performance, because it is the most effective criterion for the investor to use in deciding where and how much to invest. The basic idea is to take a measure of profitability and divide that by a risk measure. As with any examination of investment performance, it is important to make sure that you have chosen a sufficiently rich period of investment history in your evaluation.

The simplest risk-adjusted performance measure is the ratio of compounded annual gain to drawdown, or GPA, short for gain per annum. A negative GPA indicates a loss in value.

One reason this measurement is useful is its intuitive interpretation: Comparing GPA and drawdown tells you how many years of average performance are required to recover from the worst historical loss in the period studied. For example, in 2000–2003, the drawdown of the S&P 500 was 45 percent. The long-term average return of large U.S. stocks has been approximately 11 percent per year. Therefore, the GPA-to-drawdown ratio has been approximately 1-to-4, or 0.25. This means that an investor should expect to require four years to recover from a severe bear market.

Another Measure — The Sharpe Ratio

A less intuitive but more widely used measure of risk-adjusted performance is called the Sharpe ratio. The performance measure used is not simply the average return. Rather, Sharpe ratio calculations use something called the *excess return*. The excess return is that amount of profit above what was earned from a risk-free investment. For example, if your investment returned 8 percent per year on average for the past 10 years, and if 90-day Treasury bills (used for the risk-free return part of the equation) returned an average of 3.6 percent per year during the same period, your excess investment returns is 4.4 percent (3.6 percent subtracted from eight percent). ●

Reduce Risk, Not profits, with Diversification

Diversification in your investments is often more difficult to achieve than you might think. If you are investing in ETFs, most of which are well diversified to begin with, diversification cannot turn straw into gold. On the other hand, if your investments consist of individual

company stocks, diversifying can greatly increase the safety of your portfolio.

How to Determine What Should Be in the Optimal Portfolio

Procedures to determine the precise “best” portfolio mix remain the subject of debate. However, here are some commonsense guidelines:

- Identify the range of investments available to you.
- Use historical performance during a full market cycle that includes both a bull and bear market period for each investment.
- Find the risk-adjusted performance for each investment option during the period.
- Generally speaking, those investment options that have the best historical risk-adjusted performance should be most heavily weighted in your portfolio.
- Use a spreadsheet program such as Excel to calculate the portfolio's risk-adjusted performance. Then try a variety of portfolio weights and calculate how changing the weight of each component affects the portfolio's risk and return.

The major caveat in making investment decisions for yourself based on this type of analysis is that future results will probably not exactly repeat the past. What will transpire over the longer term is anybody's guess. As a consequence, the optimal portfolio in the future is unknowable. However, the qualitative conclusion that investors are better off (from the perspective of balancing risk and reward) by including both stocks and bonds in their portfolios compared to holding only one or the other remains valid. ●

The One-Decision Portfolio

The one-decision portfolio describes a specific application of the principle of diversification by giving you an investment recipe that in the past has generated attractive returns at low risk. The goal is to provide the best possible investment that requires only a minimal time commitment and does not require you to follow the market except to check on the value of a handful of holdings once each year.

As a general rule, diversification works best when you include a mix of different investments whose price movements have not usually tended to coincide with each other (said to be uncorrelated). These three areas — REITs, small-cap value and S&P 500 — have historically had a relatively low correlation with each other.

Summary: INVESTING WITH-EXCHANGE TRADED FUNDS MADE EASY

A mix of assets that has been far safer than stocks alone and far more profitable than bonds alone is 50 percent in bonds/cash and 50 percent in equity funds. The equity portion of the portfolio is simply the blend of 40 percent S&P 500, 40 percent REITs and 20 percent small-cap value. The income portion of the one-decision portfolio is 60 percent cash/40 percent intermediate-term investment-grade bonds.

Putting all this together results in the following one-decision investment mix: 20 percent S&P 500 Index, 20 percent diversified REITs, 10 percent diversified small-cap value stocks, 20 percent diversified intermediate-term investment-grade bonds and 30 percent cash (90-day Treasury bills, money market or bank CDs). Less conservative investors can omit the cash position while leaving the other four investment categories in the same proportion.

ETFs are available to gain exposure to each of these areas, except for cash. Particular selections include these:

- S&P 500 Depository Receipts (SPY) for the S&P 500
- iShares Cohen & Steers Realty Majors Index Fund (ICF) for REITs
- StreetTracks Dow Jones U.S. Small-Cap Value Index Fund (DSV) for small-cap value stocks
- iShares Lehman Aggregate Bond Index Fund (AGG) for intermediate-term investment-grade bonds

Rebalancing

What will your investments look like at the end of the year? In general, your investments will deviate from the prescribed portfolio because each of the components will have grown at a different rate. To restore the original balance in your portfolio, you have to sell off part of the investments that performed more strongly than the overall portfolio and place additional capital into those areas that did not earn as much as the entire portfolio. Rebalancing should be done after holding for one year and one day, rather than rebalancing on the same date each year. This way, any gains you realize will be taxed at the more favorable long-term capital gains rate. ●

An Asset Allocation Model for Small– Versus Large-cap ETFs

There have been great rewards for investors who have made good decisions about when to switch from large-caps to small-caps and back. Unfortunately, neither ETF sponsors nor the managers of most mutual funds will

decide for you when you are likely to be better off in small-caps or large-caps.

The universe of small-cap stocks represents a wide range of industries, but the following factors seem to have influenced the relative performance of small-cap stocks overall:

- Strong economic growth
- Strong corporate profit growth
- Easy credit conditions
- Geopolitical stability

The asset allocation model that determines whether to be in small- or large-cap ETFs operates based on the premise that major trends favoring one or the other will continue to persist for years at a time, as they have in the past. The model consists of one simple rule: Invest for the coming year in whichever of the two alternatives returned more in the previous year.

As a practical matter, individual investors will not have access to total returns of benchmark indexes information on the last day of the year. However, you can get a good idea of the total return of the two ETFs that track these benchmarks from information available online: the iShares Russell 2000 Index Fund (IWM) and the iShares Russell 1000 Index fund (IWB).

To calculate the total return of an ETF, you need the price at the beginning and end of the period you want to study. Fortunately, ETF price and distribution information can be obtained by going to <http://finance.yahoo.com> or <http://moneycentral.msn.com/investor/charts/charting.asp>.

ETF Share Prices Drop by the Amount of a Distribution

The IRS requires ETFs and mutual funds to make taxable distributions to their shareholders so that they will pay taxes similar to someone who held the underlying individual stocks directly. Distributions are taxable to you whether or not you actually sell your ETF shares. It is important to recognize that the amount of a distribution does not affect your investment return from an ETF or mutual fund.

Because a distribution does not reflect the creation of new wealth, the amount distributed has to come from somewhere. The source of taxable distributions is the ETF's underlying assets. Therefore, the amount paid to you as a taxable distribution must reduce the fair value of the ETF shares. As a result, ETF share prices drop by the amount distributed.

Summary: INVESTING WITH-EXCHANGE TRADED FUNDS MADE EASY

Be careful when buying mutual funds or ETFs near the end of the year, lest you end up paying taxes on a distribution that reflects profits you never enjoyed. ●

Choosing Between Growth and Value ETFs

There are no universally accepted criteria to define precisely what is considered to be a growth or value stock. The lack of consensus has given rise to multiple growth and value ETFs, each of which is based on its own methodology.

Even though the universes of growth or value stocks contain multiple industry groups, certain changes in the economic climate have caused these diverse collections of stocks to move in relative unison. For example, three economic factors have favored value stocks over growth stocks historically: sharply rising commodity prices, a strong U.S. dollar and accelerating economic growth.

The Concept of Relative Strength

It is useful when making a decision about what to buy or sell to be able to tell at a glance which of two investments is currently stronger than the other. You can accomplish this by plotting the *relative strength* between two investments, which is simply a graph of the value of one investment divided by the value of the other.

The simple rule for rebalancing between value stocks and growth stocks is this: *A disparity of 10 percent in relative performance between growth and value defines the current long-term trend.* ●

International Investing

Investing abroad has become popular in recent years because foreign stock markets have in many cases been stronger than our own. However, investing abroad has inherent obstacles. Currency risk is added to whatever local stock market risk exists. This currency risk has no offsetting expectation of reward. Moreover, transaction costs are typically higher abroad than they are for managers who buy on U.S. exchanges.

An investor can improve his investment performance by taking positions in international stocks only when a long-term trend is favorable. You can identify a major trend by a 15 percent disparity in the performance of foreign versus U.S. stocks. ●

How to Use Interest Rates

Interest rates are perhaps the most important factor that influences the stock market. Generally speaking a six-month time frame for analyzing interest rate trends has produced the most useful tools to gauge the stock market. Two important features of the interest rate climate are important to follow when you're an equity investor: whether interest rates as a whole are rising or falling and whether it costs more for the U.S. Treasury to take out long-term loans or short-term loans.

Two interest rate climates have been bad for stocks. The first interest rate indicator is the six-month change in the yield on 10-year Treasury notes. When this interest rate is higher than it was six months ago, the interest rate environment is unfavorable for stocks. When the 10-year yields are lower than they were six months ago, the interest rate climate is favorable for stocks. The second warning sign is called an *inverted yield curve*. This describes a bond market in which the interest rate on long-term bonds is lower than the rate on short-term bonds. ●

The Ultimate ETF Investment Program

An investor can improve the performance of a strategy that continually invested in the S&P 500 and in small-cap value ETFs by following a three-step ultimate investment approach that has delivered attractive returns at reasonable risk:

1. Diversification – allocate 25 percent of your assets to investment-grade U.S. bonds and 25 percent to REITs using ETFs.
2. Decide whether international or U.S. stocks are favored; if U.S. stocks are favored, evaluate the interest rate climate. From that point, make a 25 percent allocation to large U.S. company stocks (SPY), foreign stocks (EFA) or a money market fund.
3. Select the best investment style from large-cap value, small-cap value, large-cap growth or small-cap growth and then determine whether growth or value is stronger. After you have made this decision, you can select a small- or large-cap ETF and allocate the final 25 percent of your portfolio.

The bottom line is that the rich variety of ETFs that are available and the degree of competition among ETF sponsors and index providers offer you the opportunity to be selective when you are shopping for ETF investments. Take advantage, and you will have a leg up on most other investors. ●

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Summary



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Personal Finance

Go Global And Make Mega-Money While The World Watches And Waits

Investment Megatrends

THE SUMMARY IN BRIEF

Megatrends are large social, economic or political changes that are slow to form — however, once in place, their influence can last decades. Demographics are a type of megatrend, and even though these trends are somewhat easy to spot, few, if any, investors focus enough on demographic trends as they make their investment decisions. These unique demographic trends can create investment opportunities, if you understand the link between demographics and investments.

Fortunately, Dr. Bob Froehlich understands this link quite well. As vice chairman of Scudder Investments, a part of Deutsche Asset Management, Froehlich applies dedicated research to discovering what lies ahead for the global economy, and how investors can capitalize on trends as they develop. He is a regular on CNBC, Fox, CNN and Bloomberg and is chairman of the Investor Strategy Committee, the first of its kind on Wall Street.

This summary gives investors a method to ride a global investment tide that's been building for more than a decade. Froehlich has done the legwork for you, and he shares the insights you need to make the most of your international portfolio.

IN THIS SUMMARY, YOU WILL LEARN:

- The power of demographic trends and how to use them to your advantage.
- The three major measures of demographics.
- How baby boomers hold the ticket to market success for the next 10 to 15 years.
- Why more than a decade after the fall of the Berlin Wall, Europe's economy is still feeling the effects.
- Why Japan's aging population holds the secret to good health and potential gold for investors.
- The reason China's growing consumer culture will put money in your pocket.
- The 20 companies you should invest in to develop an investment megatrends portfolio.



By Dr. Bob Froehlich

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THE COMPLETE SUMMARY: INVESTMENT MEGATRENDS

By Dr. Bob Froehlich

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Investment Megatrends

John Naisbitt, perhaps the greatest “futurist” of our time, first coined the term “megatrends” in the early 1980s. Megatrends are large social, economic or political changes that are slow to form, however, once in place, their influence can last decades.

Demographics are a type of megatrend. Even though these trends are somewhat easy to spot, few, if any, investors focus enough on any demographic trend as they make their investment decisions.

During my investment career, I have had the opportunity to travel the globe meeting with financial advisors and business and political leaders around the world. As a result of my extensive worldwide travels, I have witnessed firsthand the evolving demographic changes taking place around the globe. These unique demographic changes can create investment opportunities if you understand the link between demographics and investments.

There are hundreds of demographic trends developing around the world. I have identified the four global demographic shifts that can make you rich over the next decade. While the numbers behind these global demographic shifts are important, they are about more than mere numbers. They are the stories of people and societies, the faces of children I have met from all walks of life, they are elders from different cultures with different values and traditions who have given me advice that somehow all come together to create the global demographic landscape. If you know where to look, this landscape is full of investment opportunities. ●

Understanding The Power of Demographic Trends

It took us a long time to realize the power of demographic trends on Wall Street. We are in good company because throughout history, few — if any — civilizations have understood the potential power of such trends, even if they are compiled demographic statistics. The governments of ancient Egypt, Rome and China all collected demographic data; their scope, however, was very limited. They counted their population so they would know how many people they could put in their military and how many people they could tax. Although in these respects, demographic surveys have been around since ancient times, the real foundation for demographics was set in the 1960s. It was then that governments moved beyond simply counting the living for tax and military purposes and began tracking how many people died, as well as compiling birth and marriage data.

The Father of Demographics

In the early 1600s, priests in London were required by law to compile a list every week showing how many of their parishioners had died of the plague. These lists were called Bills of Mortality. The government used the lists to identify where outbreaks of the plague were occurring so they would know which areas to quarantine. The Bills of Mortality eventually expanded to list other causes of death as well. Later, data on births and weddings were added.

It was from the Bills of Mortality that the founder of demography arose. John Graunt was a simple London merchant who was fascinated by these lists. Even though he had no formal training, the more he analyzed the Bills



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Summary: INVESTMENT MEGATRENDS

of Mortality, the more questions he had. It became his life's work. In 1662, he wrote a book titled *Natural and Political Observations Made Upon the Bills of Mortality*. His book raised issues about family size, health and place of employment. It was this book that finally helped people recognize the potential in studying demographic trends. As interest began to grow, first in medical statistics tracking specific causes of death, statistical offices had to be created to gather and keep track of all this information. It wasn't until the 1800s that the concept of a national census finally caught on.

What Is Demographics?

What exactly did John Graunt discover? *What is demographics?* In its most basic form, demographics is the study of population change and the underlying structure of that population. Demographics is a basic and simple concept. A limited number of events can change populations, and each of these events can be counted and tracked. These events are commonly referred to as the *demographic equation*. The equation sets forth that a country's population size can only change because of three types of events: births, deaths and migration.

From a technical perspective, demographic trends aren't listed as births, deaths and migration. When statisticians track the individual births of an entire country, the nation's trend is known as fertility. Likewise, the results of tracking the individual deaths of an entire country is known as mortality. Thus, *fertility, mortality and migration* make up the true demographic equation that drives all population changes.

Fertility. Fertility is simply the propensity of women in any given population to bear children. While to most casual observers, fertility (births) and mortality (deaths) both appear to be simple and straightforward, the analysis of fertility is much more complicated. First, people only die once and everyone dies, so mortality statistics are relatively easy to count. But fertility is much different. Women may have several children, or none at all. So with fertility, you are conducting an analysis of a repeated event. Second, death is typically determined by medical factors, and human factors only influence it to a limited degree. People do not usually choose to die, but their life may end due to an accident caused by someone else. That would be an example of a human factor, not a medical factor influencing mortality. But for the most part, medical factors, not human factors drive mortality. Just the opposite is true with fertility. Birth in most populations is subject to individual choice although governments may adopt laws that focus on and affect fertility. The simple way to think about it is that people get to

choose to have a child; they generally don't get to choose to die.

Mortality — Crude Death Rate. Mortality rates will vary greatly based on different characteristics. The most obvious is age. But mortality rates can also be influenced by a person's occupation and also by a person's sex. To understand mortality trends, we must do two things. First, we have to identify and measure mortality differences. Second, and even more important, we have to line up those differences to a particular characteristic. Think of it this way, if the mortality rates of two occupations differ greatly, that doesn't necessarily mean that the death was influenced by the occupation. Maybe this occupation requires more experienced people, and thus those people are older. So did the occupation contribute to their death or should we have focused on their age characteristic as the real factor?

The simplest and most widely used measure of mortality is the crude death rate. It is a simple calculation of the total number of deaths in a given period (usually one year) divided by the total population.

Migration. Migration is the third and final element of the demographic equation. Migration has evolved over time into the weak link of the three elements of the demographic equation. Statisticians spend more time, attention, analysis, research and understanding on fertility and mortality, whereas migration always comes in a far distant third. The reason is simple: Migration is the hardest and most complicated of the three elements to measure and analyze. Migration usually involves more than one country's population. When people move from the country where they were born to a different country, that move affects the population of both countries. Also, migration is not a one way street. People are traveling in both directions at the same time.

What Should You Look For?

With the foundation now being set for the demographic equation of fertility, mortality, and migration, it is time to interpret all this demographic data.

There are four basic rules to follow when looking at any demographic data:

One: Focus on the extremes: If any number is a real outlier, it deserves all your attention and you need to find out why it exists. Outliers occur for one or two reasons. Either there is a flaw or error in the data that caused the outlier or it was a unique circumstance that could give you real clues to future trends.

Two: Cluster the data. You will always be able to group or cluster some of the data. Then within that cluster,

Summary: INVESTMENT MEGATRENDS

look for natural groupings. Are most people in this cluster from the same occupational category; or are they in a certain income level, be it high or low; or possibly do they all have poor health? Clustering allows you to begin to see beyond the numbers.

Three: Identify patterns. Fertility, mortality, and migration all vary by age, occupation, and ethnicity. These patterns will help develop the groundwork for future needs.

Four: Draw comparisons. This is the most important of the four rules. Draw comparisons, draw more comparisons, and when you are done, draw even more comparisons. The real underlying power of demographics is in drawing comparisons of the data with other places around the world. Then, you need to repeat the exact same procedure; only this time, compare your data to different time periods in the part of the world from which this information came. That way you can quickly see how this demographic trend has evolved and how that trend compares with the rest of the world.

Why Not Investments?

Did you ever wonder why demographic data is used in government and is used in business but is not typically used to drive investment decisions? We are missing the most important tool of all in investing — demographic trends. It is not the next economic release or earnings report that should drive our investment decisions, but rather demographics. Such trends have a longer term impact and they are easier to predict. Demographics need to become an important tool for investors. The following examples show how the baby boomer demographics in the United States have created investment opportunities.

Age Characteristics

When looking at statistics and data, whether on the Internet or on a paper copy, it is not enough to know what to look for in demographic trends and where to look for them. You also must grasp just why demographics are such a powerful investment tool. If you think of demographics and age characteristics as being one and the same, you will begin to see what I mean. Just think about the factors over which demographics and your age characteristics exert a major influence. First, your age characteristics are a key determinant of your consumption patterns. Not many 16-year-olds buy reading glasses. Likewise, not many 60-year-olds buy acne cream. And I've yet to see many 20-year-olds searching for just the right hair product to wash away the gray.

Second, your age characteristics greatly influence your level of savings and investing. Even though you may have great self-discipline and motivation to invest when you're younger, it is difficult because there are higher priorities such as raising your family or buying your first home. As you approach your first home, however, you suddenly seem to invest and save more. It is not because you are more motivated; it is because your age characteristics are now playing in your favor to help you save and invest. When you are 50, your children are grown and about to leave home and start life on their own. This frees up a great deal of cash. Also, that home that you have been paying a mortgage on for what seems like forever is just about paid off, which also frees up your cash flow. And, finally, at age 50, your employer pays you the financial rewards that you thought that you deserved at age 22. Your age characteristics just might be the most important factor you need to understand saving and investing.

Third, your age characteristics will determine both the size and makeup of your household. Very few teenagers think of starting a family, whereas that is on the top of the list for most young adults in their twenties.

Fourth and finally, the age characteristics of a nation have a strong influence on government policy. When a nation is driven by younger age characteristics, it spends money on schools and recreational programs. Conversely, a nation that is driven by older age characteristics tends to spend its money on retirement and medical benefits.

If you are an investor and you know what people are going to buy, when they are going to save and invest, how many houses are going to be needed, and how many people will live in those houses, as well as what the government policies are going to be, why would you need to know anything else? In the following sections I will explain the four most dramatic demographic shifts going on in the world today. After that, we will construct an Investment Megatrends portfolio based on these landmark demographic shifts, and together we will turn demographic trends into investment opportunities. ●

Global Shift 1: The Ponce De Leon Effect — The American Baby Boomers

Juan Ponce de Leon was a Spanish conquistador (Spanish term used to refer to soldiers, explorers, and adventurers). Ponce de Leon accompanied Christopher Columbus on his second voyage to the New World. He became the first governor of Puerto Rico. It was there that he first heard of the Fountain of Youth.

Over time, Ponce de Leon became dissatisfied with his material wealth, so he launched an expedition to find the Fountain of Youth. Instead, he discovered Florida, when on April 2, 1513, he reached land near what is now St. Augustine. He never found the Fountain of Youth but now almost 500 years later, the baby boomers have. The American Baby Boom Generation is more active and healthier than any previous generation in American history. But before studying these baby boomers, let's gain a broader perspective of the overall demographic picture.

The Senior Citizen-Focused Decades of the New Millennium

Now that these baby boomers are becoming card carrying senior citizens, they will be unlike any previous group of senior citizens. First, this group is not going to stand for gray hair and wrinkles. Instead of "working" in the traditional workplace, these senior citizens will focus on working at playing. And finally, they are going to be around a whole lot longer than previous demographic waves of senior citizens. Thus, unlike earlier senior citizen groups, not only will these baby boomer seniors focus on spending, they will focus on saving and investing as well. A confluence of three trends will distinguish this baby boomer generation as they become senior citizens: the travel and entertainment trend, the health and fitness trend, and the financial advice trend.

Boomer Spend

We need to take a look at what these baby boomers are buying compared to the country as a whole.

Baby boomers spend more than the rest of the nation on food away from home, which means they love to eat out. In addition, baby boomers spend more on transportation (planes, trains and cruises) than the rest of the nation; they also spend significantly more than the rest of the nation on their vehicle purchases, which means that they like expensive cars.

They also spend more on alcoholic beverages than the national average, outspending every age group in the country other than the category of adults 25 years and younger.

Demographic data can also be misleading. This doesn't necessarily mean that baby boomers drink more. My analysis suggests that they are simply paying more. Instead of cheap lite beer, they buy expensive premium imported beer. And if the whiskey is not at least 30-year-old scotch, don't even show it to them.

No matter how you cut it, these baby boomers are one of the great consumer generations. ●

Global Shift 2: The Walls Keep Tumbling Down — Eastern European Workers

It is not often that entire continents get the opportunity to recreate themselves: however, that is exactly what is happening today in Europe. When nations are in a transition, it becomes important to understand where they have come from, how they got there, and where they are going. To understand Europe, you not only must understand the sum of the parts, but must also be knowledgeable about the individual parts, or nations. What triggered this recreation of Europe? History will record that the Berlin Wall fell on November 9, 1989, but to get a more complete picture of the changes, we need to look back to August 23, 1989. On that day, Hungary removed its border restrictions with Austria, and within a month, over 10,000 East Germans fled Communist Germany through Hungary. In two months, East Germans began mass protests against the government that continued to keep them behind the Wall, blocked from pursuing opportunities in Western Europe. Unemployment ran high, while the East German government was forced to reduce state benefits, food was becoming scarce, and the quality of living was in a downward death spiral. Meanwhile, jobs were plentiful in West Germany, and the quality of living seemed to improve each month. The protests were so overwhelming that the leader of the East German government resigned on October 18, 1989.

What happened next was a series of blunders that led to the fall of the Wall. Less than a year after the Wall fell, East Germany and West Germany formally concluded their reunification on October 3, 1990. In many respects, this set the foundation for the European Economic and Monetary Union (EMU).

The European Union

The actual foundation for the EMU dates back to 1951 when a coalition was formed called the European Coal and Steel Community. It included Belgium, the Netherlands, Luxembourg, France, Italy, and West Germany. In 1973 Denmark, Ireland and the United Kingdom were added.

But it was after the fall of the Berlin Wall in 1989 and the reunification of Germany in 1990 that set the stage for diplomatic relationships between Western, Central and Eastern Europe. In 1992, the Treaty of Maastricht established the completion of the EMU as a formal objective and determined membership criteria on economic matters

such as inflation, interest rates, and budget deficits. By that time, three more countries had joined the European Community: Greece, Spain and Portugal. These 12 countries became the original members of the EMU.

In 1995, Austria, Finland and Sweden joined the European Union, bringing the total number of member countries to 15. In 2004, the last walls left in Europe finally fell. On May 1, 2004, the EMU saw its membership roll swell with the admission of 10 more countries: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia. The EMU now stood 25 countries strong, and for the first time in the modern era, Central and Eastern Europe could begin to act with one economic voice.

Double Impact of the European Union

The Iron Curtain is now gone and Eastern Europe and Western Europe have joined as one in the European Union. The first big impact of this union was the opening up of cheap labor in Eastern Europe. The easiest way to make money in business is to always find ways to do things better, faster and cheaper. The way to do things better, faster and cheaper in Europe is through Eastern Europe.

First Impact — Low Cost

When countries fall behind economically, there are ripple effects on health, welfare, and standards of living. These hardships do not turn around overnight, but with more income, things can get better. Think for a minute what the European Union means to the workers of Eastern Europe who, because of their poor standard of living, are the cheapest labor around. It is likely that more and more companies will begin to locate manufacturing operations in these countries to reap the financial benefit of low-cost workers. This, in turn, will help the overall economies of these Eastern European countries as well as help their own companies. National economic growth will beget corporate economic growth.

Second Impact — More Flexible Labor Standards

It is the shift of Eastern European workers to Western Europe that will cause the second impact: more flexible labor standards. It is no secret to anyone that extreme anti-business and anti-profit labor standards are major problems in industrialized Western Europe. Despite small concessions to management, the standards for work hours, vacations, layoffs and terminations are still greatly tilted toward the employee and against the employer, which ultimately means against profits as well. This, too, will change. As workers come from Eastern Europe to

Western Europe, they will be less demanding and more willing to accept a job working more hours with less vacation and less pay. The workspace landscape is about to change dramatically. This can create a win-win situation. The Eastern European economies get stronger while Western European companies get more profitable, which in turn will drive the Western European economies as well. This opening up of labor in Eastern Europe will finally bring about the structural reform needed in the labor laws, labor standards and labor traditions of Western Europe. ●

Global Shift 3: The Rising Sun Is Clearly Setting — The Aging Japanese Population

Throughout history, Japan has been referred to as the “Land of the Rising Sun.” Even the flag of Japan with its white background and large red disk in the center carries that message. The Japanese flag is called Hinomaru, which means “circle of the sun.” Where Japan and its rising sun are concerned, history is about to take a turn. Instead of referring to Japan as the land of the rising sun, we will now need to refer to it as the land of the setting sun, at least from a demographic perspective.

Japan is Aging

Japan is aging. By the year 2025, the proportion of the Japanese population aged 65 or older will be higher than any other age category. That will make Japan the oldest nation in the world. The most recent life expectancy figures are staggering: Japan has the highest life expectancy anywhere in the world. On the flip side, the average number of children Japanese women will bear has reached an all-time low of one child. Because of these two trends, Japan has the most rapidly aging population of any leading industrial country. The fallout from having the fastest aging population is a shrinking pool of workers to support the benefits received by senior citizens. Even in the best of market times, this demographic trend would be a problem. Because the Japanese equity markets in the past 15 years have experienced anything but the best of times, this trend is causing a real crisis in that nation.

Fiscal Impact

Now let's consider the potential fiscal impact that the aging population may have in Japan.

First, a little perspective: Japan's public finances worsened dramatically in the 1990s, which now makes dealing with its aging population even more challenging. Tax

revenues across the board spiraled lower when the housing and stock market bubbles both burst at the same time. To make matters worse, in an attempt to recover from those bursting bubbles, government expenditures rose to stimulate the economy, especially through infrastructure and big public works projects. Also, if a country's working age population is getting smaller, then a country's potential for economic growth must also get smaller. The only way around it is for productivity to rise faster than the labor force declines. ●

Global Shift 4: Napoleon was Right — The Chinese Consumer Generation

Some 200 years ago, Napoleon III likened China to a sleeping lion and warned that when China awakes “she will shake the world.” Now awakening from a long economic hibernation, China is certainly shaking the entire world, especially Chinese consumers. Within 10 years, these Chinese consumers will replace U.S. consumers as the largest and most important buying group anywhere in the world. All it takes is money. Today, only 4 million Chinese consumers earn more than \$10,000 annually. Maybe what Napoleon should have said is that when the Chinese consumer awakes, it will change the world!

China and Consumers

There are two parts to this global shift: China and consumers, together they are fueling this dramatic shift. In economic circles, a *consumer* is an individual or a group of individuals who consume goods and services in an economy. Consumers are thought to have a budgeted income that they can spend on any number of different goods or services available in an economy. It is assumed that consumers will behave rationally and will spend their budget only on goods and services that best fill their needs. In addition to buying goods and services, consumers also should invest part of their budget to increase future spending power.

The biggest change with consumers is the way the business world views them. No matter what you want to sell, to what age group, with whatever demographic features, chances are that you'll find more of them in China than anywhere else in the world. The 1.3 billion Chinese consumers represent the greatest consumption bubble in the history of time. ●

How To Develop An Investment Megatrends Portfolio

Now it's time to make some money. Let's connect the dots between these global demographic shifts — my Investment Megatrends — and the investment opportunities these shifts are creating. After briefly summarizing my investment perspective on each of the four global shifts presented here, I identify the five companies best positioned to benefit from each shift. You will then have a portfolio of the 20 global companies best positioned to make money from these four demographic shifts.

Consider these companies your Investment Megatrends Portfolio for the next decade.

Global Shift 1: The Ponce De Leon Effect — The American Baby Boomers

Several dominant themes emerge when focusing on American baby boomers. The first is that these baby boomers are going to continue to be big savers, and they are going to be looking for some financial advice. These baby boomers want to spend their retirement years looking at their grandchildren, not stock charts. The best way to invest in this theme is through brokerage and investment banking stocks because through the firm's investment banking arm, it can provide its brokers unique opportunities that other brokers can't access.

Merrill Lynch (Stock Symbol: MER): Merrill Lynch is one of the world's leading brokerage and financial management firms. The company offers the kind of one-stop shopping that the baby boomers will be looking for.

Dell (Stock Symbol: DELL): Dell Computers has one of the best and simplest business models anywhere. Dell is one of the most customer service friendly firms anywhere and Dell has over 60,000 employees worldwide waiting to customize a computer for picky baby boomers.

Carnival Corporation (Stock Symbol: CCL): Baby boomers want to see and experience it all in their lifetimes. They have the disposable income and wealth to travel anywhere they want. The best way to invest in the travel theme is through the world's number one cruise operator, Carnival Corporation, which also offers a wide array of pricing packages.

Molson Coors Brewing Company (Stock Symbol: TAP): One of the reasons that baby boomers spend so much on alcoholic beverages is that they pay more for imported beers. Coors also offers a lighter calorie beer for the weight conscious.

Johnson & Johnson (Stock Symbol: JNJ): Baby boomers are concerned about their health and fitness and the best way to do that is through Johnson & Johnson, one of the world's largest health care manufacturers.

Global Shift 2: The Walls Keep Tumbling Down —Eastern European Workers

Several dominant themes emerge when focusing on Eastern European workers and their likely impact on Europe. The first theme is that these low-cost Eastern European workers will provide a spark to economic growth, not just to Eastern Europe but to Western Europe as well, which will serve to further integrate trade and commerce among the 25-member European Union countries. The best way to invest in this increasing trade and commerce theme is in shipping.

Dryships Inc. (Stock Symbol: DRYS): Dryships are carriers of dry bulk goods. What uniquely positions them is that they serve the complete spectrum of sizes within the now vast EU. The range in demand will be very wide. They will have the ability to fill every order.

Mittal Steel Company N.V. (Stock Symbol: MT): Mittal Steel is the largest steel producer in the world, producing more than 50 million metric tons annually.

BASF (Stock Symbol: BF): If trade and commerce pick up in Europe, then the largest chemical company in the world should stand to benefit as well.

Ericsson (Stock Symbol: ERICY): If your standard of living increases, then you are more likely to buy a mobile phone and that means Ericsson wins.

Shire Pharmaceuticals Group (Stock Symbol: SHPGY): As the EU grows, Shire will benefit by being a drug company and also focusing on the specialty physician.

Global Shift 3: The Rising Sun is Clearly Setting — the Aging Japanese Population

Four dominant themes emerge when focusing on the aging Japanese population. The first is that not only does Japan have one of the oldest populations in the world but these senior citizens are the healthiest as well. Japan is ranked number one for healthy life expectancy.

Canon Inc. (Stock Symbol: CAJ): There simply is no way these healthy aging Japanese senior citizens are going to let all these memories go by without capturing them on camera or with a camcorder.

Fuji Photo Film Company (Stock Symbol: FUJIIY): This company not only offers film and paper products, but entertainment products for a growing singles population.

Konami Corporation (Stock Symbol: KNM): No company is in a better position to fill entertainment needs than the Konami Corporation, which offers digital entertainment, video games and cell phones.

Sony Corporation (Stock Symbol: SNE): Sony offers a wide array of entertainment products for Japanese singles.

Mitsubishi UFJ Financial Group (Stock Symbol: MTU): This is one of the largest banks in the world and will benefit from money coming out of Postal Service Savings Accounts.

Global Shift 4: Napoleon was Right — The Chinese Consumer Generation

Five dominant themes emerge when focusing on the Chinese Consumer Generation. The first is that young Chinese consumers are buying things made in Japan, unlike their parents who still boycott such products because of the Japanese invasion and occupation of China in the 1930s. To these young Chinese consumers, that doesn't matter. They make their shopping decisions based on the quality of the product along with the price and that product's brand reputation.

Toyota Motor Corporation (Stock Symbol: TM): These young Chinese consumers are evolving from riding bikes to mopeds to autos. No company is better positioned to serve them than Toyota.

PetroChina Company (Stock Symbol: PTR): PetroChina produces over two thirds of China's oil and gas. It has its own domestic exploration business and already owns close to 10,000 miles of natural gas pipelines.

China Mobile (Stock Symbol: CHL): China has the largest group of mobile phone users anywhere in the world at 325 million. China Mobile will dominate because of its service.

Yum Brands, Inc. (Stock Symbol: YUM): In China, Yum operates Kentucky Fried Chicken, Pizza Hut, Taco Bell and Long John Silver's.

Avon Products, Inc. (Stock Symbol: AVP): The rising earning power of Chinese women means that Avon's products will grow in popularity. Avon is also already selling its products in China. ●

· Book 25 of 44 ·

Summary



Twelve of the World's Best Investors Reveal the ONE Strategy You Can't Overlook

Just One Thing

THE SUMMARY IN BRIEF

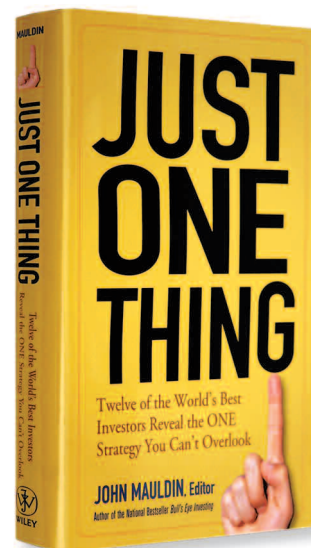
In traveling the shifting terrain of the financial world, one is often met with confusing and even contradictory directions. In the search for a reliable path, there's nothing like a personal guide — one who can show you the most direct route to your goal. In *Just One Thing*, author John Mauldin offers an incomparable shortcut to prosperity: the personal guidance of an outstanding group of recognized financial experts, each offering the single most useful piece of advice garnered from years of investing.

Never before has such an esteemed assembly of financial gurus offered their most valued insights in such a succinct manner. With uncommon clarity, each contributor presents the most precious kernel of advice — just one thing — that he would pass on to his own children and his children's children.

In this summary, these 12 investment gurus share “just one thing” each of them has learned: Rob Arnott, Bill Bonner, Ed Easterling, Mark Finn, Dennis Gartman, George Gilder, Andy Kessler, Michael Masterson, John Mauldin, James Montier, Richard Russell, and A. Gary Shilling. These are practitioners — men who have enjoyed extraordinary success in the market; professional investors who can tell you what works.

IN THIS SUMMARY, YOU WILL LEARN:

- How to boost returns with “the 2 percent alpha solution.”
- Why you should use “volatility throttling” when assembling your portfolio.
- The secret of “investing in the fog.”
- How to deal with risk when positioning your portfolio.
- How psychology often trumps economics.
- The strength of a nonconsensus investment theme.



edited by John Mauldin

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THE COMPLETE SUMMARY: JUST ONE THING

edited by John Mauldin

The editor: John Mauldin is a leading expert on investment issues. As president of Millennium Wave Investments, he is involved in private money management, financial services, and investments. A prolific author, his books include the bestseller, *Bull's Eye Investing*.

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Signposts in the Fog

The Author: *Andy Kessler was a research analyst and investment banker for some of the biggest firms on Wall Street. He went on to co-found Velocity Capital Management, a hedge fund that turned \$80 million into \$1 billion in five years.*

A stock price is nothing more than the present net value of a company's future earnings. All you need to know is how much a company is earning today, how fast it is growing, and what discount rate to apply to future earnings to get that net present value. Formulas rarely have an input for risk. Even if they did, it's an unquantifiable number. A risk-adjusted growth rate is about as specific as economists can come up with. When a company's stock is out in the open, everybody can see it. Everybody agrees on its prospects. But we don't live in a static world, Kessler writes, so he won't touch a stock whose prospects are in the bright sunshine. "If everybody knows something, you ain't gonna make money on it."

You Can't Make Money Standing in the Sunshine

Kessler writes that he would rather be out in the fog where nobody knows anything. Then, if he's good, he can peer out into the fog and spot some signposts to show the way to a higher level.

This whole idea of investing in the fog is not about being a contrarian. It's about seeing things before others. Investing in the fog is about seeing things others can't. Most people get in the fog and panic, but the trick is to get in the fog and feel comfortable, let your imagination run wild, imagine what things might look like up ahead, make out vague outlines in the distance, and invest as if those outlines were real things.

Over time, if those outlines become real, or even close to being real, you will have invested at such a discount to the eventual value that you will make a killing. Just don't forget that you are no longer in the fog when you can see what was once an outline and is now living, breathing reality. Get back into the fog. The stock market always looks ahead.

Pick the Right Signposts

So what are these signposts? Quite simply, they are big trends that you believe in, have confidence in, know in your gut to be true, and have 99.99 percent probability of coming to fruition. These aren't picked randomly or without lots of work, tons of sweat and consternation. Pick the wrong trend and you are following signposts off a cliff.

Here are two real signposts for investing in the fog:

1. Elasticity: lower cost creates its own huge markets. Intel founder Gordon Moore made the observation that chip density doubles every 18 months. Elasticity is just the financial explanation of how the computer industry grows whenever prices of bits or gates or functions drop.

2. Intelligence moves out to the edge of the network. Google is the best example of intelligence at the edge. Google doesn't tell you what you are searching for; it scours the edge of the network for that information and uses an algorithm to calculate if it might be what you are looking for. The intelligence is at the edge vs. the center. ●

The Triumph of Hope Over Long-Run Experience

The Authors: *Mark T. Finn is chairman of Vantage Consulting Group. His son Jonathan is the chief investment*



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officer at Vantage.

Past performance dominates investors' decision processes so much that past performance data may be the most misused information in the investment business. Performance measurement can be useful in understanding the sources of a manager's performance and in comparing a manager to a peer group or benchmark. However, this is a process of explanation of how the manager achieved past success (or lack thereof), not prediction, and is not the same thing as relying on past performance to predict future performance. Unfortunately, in practice, decision-makers overweight historical returns in the decision equation. Sadly, they continue to repeat this mistake time after time, despite bad outcomes. This is called the *triumph of irrational hope over long-run experience*. Past performance may contain some information useful for prediction, but almost certainly not in its raw, reported form.

Why Do Investors Rely on Past Performance?

Studies have shown that even managers with the best long-term records commonly underperform the market 40 percent of the time, and it is not unusual for them to have periods of three to five years of sub-par performance. Why do investors assume past performance is predictive? A big factor is our lack of appreciation of the level of uncertainty and the central role uncertainty plays in just about everything related to investing.

There is a branch of probability theory that offers some useful insights into how to integrate different sources of information when making predictions. It is called *Bayesian statistics*. In assessing an investment manager's ability (and hence likelihood of producing superior future performance), there are three sources of information:

1. One's prior belief as to the range of abilities across active managers in general. What would the range of alphas be so that two-thirds of all managers' alphas will fall within that range? Informal surveys done with groups of professional investment managers showed that they thought the average manager would produce a zero alpha and that two-thirds of all managers would fall within -2 percent to +2 percent alpha, producing total returns within a range of 2 percent below to 2 percent above the market's return for any given period.

2. One's belief as to a manager's alpha based on an in-depth understanding of the people, process and philosophy employed by that manager. This source of information is any information about that particular manager independent of historical performance.

The 'Not-So-Simple' Rules of Trading

Dennis Gartman has been a bank trader, a member of the Chicago Board of Trade, a private investor, and the writer of *The Gartman Letter*, a daily newsletter he's been producing for 20 years. Here are Gartman's "Not-So-Simple" Rules of Trading:

- Never, ever, under any circumstance, add to a losing position ... not EVER! Averaging down into a losing trade is the only thing that will assuredly take you out of the investment business.
- Learn to trade like a mercenary guerrilla. We must learn to fight and invest on the winning side, and we must be willing to change sides immediately when one side has gained the upper hand.
- Capital is in two varieties: mental and real, and, of the two, the mental capital is the most important. Holding on to losing positions costs real capital, but it can exhaust one's mental capital even more seriously, as you become more and more fearful with each passing minute.
- The objective of what we are after is not to buy low and to sell high, but to buy high and to sell higher, or to sell short low and to buy lower.
- Sell markets that show the greatest weakness; buy markets that show the greatest strength.
- In a bull market we can only be long or neutral; in a bear market we can only be bearish or neutral.
- Markets can remain illogical far longer than you or I can remain solvent.
- Trading runs in cycles; some are good, some are bad, and there is nothing we can do about that other than accept it and act accordingly.
- To trade and invest successfully, think like a fundamentalist; trade like a technician.
- Keep your technical systems simple. Simplicity breeds elegance.
- In trading and investing, an understanding of mass psychology is often more important than an understanding of economics.
- Do more of that which is working and do less of that which is not. This is the most important rule of all.

3. The historical performance record of a manager. There are a few situations where past performance may be predictive of future performance. These

Summary: JUST ONE THING

situations arise when several criteria are met; the benchmark is a very good representation of all aspects of the manager's style or habitat. However, situations where these criteria hold are quite rare. Indeed, they are so rare that past performance in most cases is useless in predicting future performance.

Expert Recommendations

Look hard at all risks associated with estimating performance measures, such as information ratios. Bring into the decision equation all the information on the manager's process you can. Factor measurable beta, or risk measurement, out of historical performance, while relentlessly searching for uncorrelated strategies. Use a Bayesian approach. Dampen your enthusiasm and let common sense and experience play an important role in the decision process.

When the time comes to put the portfolio together, weight the allocation to your various managers by the inverse of their variance (or volatility). This is called *volatility throttling*. In other words, take their volatility and weight your allocation to them by the inverse of the volatility (one over their volatility). This means the lower-volatility managers will get more of your portfolio because they probably have less noise — events and factors that are independent of the manager's decisions — in their particular portfolio management style. In essence, this will tend to dampen the noise in your personal portfolio. ●

The Long Bond

The Author: *A. Gary Shilling has been a columnist for Forbes for more than 20 years.*

Find an important, nonconsensus and long-term investment theme — and stick with it.

To be useful, an investment theme must have the potential to make serious money. It must also be nonconsensus. With today's widespread and instantly available information, the consensus view is fully reflected, or discounted, by security markets. If the vast majority of pundits expects overall corporate earnings to be up 10 percent in a given quarter, stocks won't move much if that forecast does, in fact, turn out to be true. Only a correct forecast of, say, a 20 percent gain adds any value because when it is realized, equities will move appreciably.

An investment theme must also be valid for many years to be highly successful for most investors. A correct forecast of unexpected weakness in payroll employment in a particular month would probably spur Treasury bond

prices, but the gains might erode quickly if the weekly jobless benefit claims in succeeding weeks were well below the consensus forecasts.

Hang In There

Persistence in the face of occasional adversity and constant disbelief by others makes investment success possible. Keep the big picture in perspective. Don't get carried away with the ongoing chatter on the financial news TV channels or the seemingly important but ephemeral stories in the financial press. Bear in mind that the media offers absolutely no guidance on what's important and what isn't. ●

Risk Is Not a Knob

The Author: *Ed Easterling, president of Crestmont Holdings, a Dallas-based investment and research firm, is the author of the book Unexpected Returns.*

Risk can be friend or foe, and as an investor you will succeed or fail depending on how you deal with it. Risk is an inherent condition of all investments and should be respected, assessed, managed, and prudently controlled. Despite all the ways that risk can be measured and assessed, risk is the likelihood that your investment will lose money.

Higher risks can lead to higher losses unless addressed with the tools of risk management. Risk is not a knob to be turned for greater returns. Turning the knob invites more risk; it does not drive returns. During the past few decades, modern portfolio theories became inverted as investors were led to believe that higher returns necessarily emanate from higher risk. However, risk does not drive returns; returns are what investors seek to compensate for the effects of risk by appropriately pricing the investment.

Caveat Investor

Determine the risks inherent in potential investments, assess the reward potential, and make rational and prudent decisions. Shy away from unacceptable risks, and position your portfolio to profit consistently.

Whether you take the traditional approach to relative return investing or the progressive approach of skill-based investing, risk is integral to your portfolio. Savvy investors understand the risks and their underlying assumptions and adopt a more businesslike approach to investing, reducing or hedging unwanted or undesirable risks. A well-constructed investment portfolio, like a well-run business, addresses its vulnerabilities and reacts to the ever-changing environment.

Remember the first principle of Harry Markowitz's Nobel Prize-winning modern portfolio theory: Assumptions are your responsibility. Be sure that your assumptions reasonably and rationally assess risk as you develop, structure and diversify your investment portfolio. Keep in mind that the long-term average is rarely a good assumption.

Risk is an ingredient in every investment, not simply a key to higher returns. ●

Psychology Matters

The Author: James Montier is the global equity strategist for Dresdner, Kleinwort Wasserstein based in London, England. He is the author of Behavioural Finance.

Investing is all about making choices and decisions. Understanding how our brains work is vital to understanding the decisions we make. One of the most exciting developments in cognitive psychology over recent years has been the development of dual process theories of thought. It is a way of saying that we tend to have two different ways of thinking embedded in our minds: One is founded in the emotional part of the brain; the other is logical and deductive in the way it handles information.

Emotion can both help and hinder us. Without emotion, we are unable to sense risk; with emotion, we can't control the fear that risk generates. When we are relaxed and emotion-free, we underestimate how we would act under the influence of emotion.

Self-Control Is Like a Muscle

Unfortunately, a vast array of psychological research suggests that our ability to use self-control to force our cognitive process to override our emotional reaction is limited. Each effort of self-control reduces the amount available for subsequent self-control efforts.

One research study found:

1. Under emotional distress, people shift toward favoring high-risk, high-payoff options, even if these are objectively poor choices.

2. When self-esteem is threatened, people become upset and lose their capacity to regulate themselves.

3. Self-regulation is required for many forms of self-interest behavior.

4. Making choices and decisions depletes this same resource.

5. The need to belong is a central feature of

Common Investor Biases

Here are 10 biases that have direct implications for investment:

1. I know better, because I know more. More information is not better information; it is what you do with it that truly matters.

2. Big is the same as important. Investors seem to almost continually overreact to firms with historically high earnings growth, rather than focusing on the likely prospects in the future.

3. Show me what I want to see. Investors look for information that confirms what they already believe.

4. Heads was skill, tails was bad luck. Investors tend to attribute good outcomes to skill and bad ones to bad luck, making them overlook mistakes they could learn from.

5. I knew it all along. After something happens, investors are sure they knew it all along because it is so clear in hindsight.

6. Irrelevant input has value. Investors tend to anchor to previous numbers, no matter how irrelevant to the current situation.

7. I can make a judgment based on what it looks like. Investors will project high growth for a company that has had high growth in the past.

8. That's not the way I remember it. Investors tend to rely on their own experience instead of statistics or experience of others.

9. If you tell me it is so, it must be true. Investors believe what they see is what they get with financial information when they should be analyzing it.

10. A loss isn't a loss until I take it. Once investors own something they start to place a higher value on it and would rather keep the status quo than give it up, even if there is no intrinsic value.

human motivation, and when this need is thwarted, the human being ceases to function properly.

Imagine a fund manager who has just had a noticeable period of underperformance. This manager is likely to feel under pressure to start to focus on high-risk, high-payoff options to make up the performance deficit. He or she is also likely to feel his or her self-esteem is under threat. The fund manager is also likely to begin to become increasingly myopic, focusing more and more on the short term. All of this is likely to be particularly pronounced if the position run resulting in the underperformance is a contrarian one. Effectively, pretty much all the

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elements that lead to the psychology of irrationality are likely to be present in large quantities.

Having an investment process that incorporates best mental practice requires you to step back from the hurly burly of day-to-day market turbulence and understand how to apply psychology's findings to your own behavior. ●

The Means Are the Ends

***The Author:** Bill Bonner is the president and CEO of Agora publishing, one of the largest financial newsletter companies.*

There are only two ways to get what you want in life: There are honest means and there are dishonest ones. There are economic means and there are political means. There is persuasion ... and there is force. There are civilized ways ... and barbaric ones. When economists endeavor to get people to do what they want — either by offering them money that is not their own, by defrauding them with artificially low interest rates, or by printing up money that is not backed by something of real value (such as gold) — they have moved to political means to accomplish their goals. Every time political means are used, they interfere with the private, civilized economic arrangements that actually get people what they want.

Mind Your Own Business

You can never know where your actions will lead, or what will happen next in the world around you. What is a person to do? All you can do is become engaged in the struggle for a better world, say the existentialists. Here is other advice: Mind your own business.

In public life, you may be wrong more often than not. If your advice involves forcing someone else to do something ... or deceiving him or her into doing it ... or any other political means of getting what you want, you are almost certainly wrong. You are merely interrupting someone else's private ambitions — and his or her economic means of realizing them. There are no better means for people to get what they want than the economic means — that is, the private, civilized, voluntary arrangements that they work out themselves.

We're not smart enough to know whether one person's plan for world improvement will actually make the place better. All we know is whether the means the person uses are civilized. A businessman can cheat his customers and gain a temporary advantage. So can a great leader invade a neighbor and seem to be on top of the world — for a while. These are solutions to

problems. But in both cases, resorting to political means to achieve the ends they craved took them over to the dark side of life. They are no longer doing civilized things, but barbaric ones.

The ends are beyond us: We never know what will happen. All we have is the means. That is all we control. But if we use the means of civilized people — the economic means — to get what we want, we will not necessarily get what we want, but at least we will deserve it. ●

The 2 Percent Solution

***The Author:** Rob Arnott is chairman of Research Affiliates, runs an \$8 billion fund for Pimco, manages a few hedge funds, and is also the editor of the *Financial Analysts Journal*.*

We can improve on capitalization-weighted indexes like the S&P 500. Any index that is replicable, objective, transparent, and focused on large and liquid companies, which are easily traded, is a potentially useful index. Any such index that is valuation-indifferent should beat the capitalization-weighted stock market. If we don't care what price to earnings ratios are or what the price is when setting how large our investment in an asset should be, we should beat cap weighting in the long run.

What could we do to accomplish this goal? We could find the thousand largest companies by book value, and create an index weighted by book value. In this fashion, we pay no regard to the price or the market capitalization, simply indexing by book value.

You can do anything of this sort, anything that captures the scale of a company, so you have a bias toward large and liquid companies that is replicable and objective but that doesn't pay attention to valuation.

Indexing Works

Fundamental indexing works especially well in an environment of recession or a bear market or rising rates. But it also adds modest value in the more benign environments, with economic expansion, falling interest rates, and a bull market in stocks. Value investing generally does not add value during expansions, bull markets, or periods of rising rates.

Is it an index? Of course it can be an index. Is it passive? Yes: It's replicable, formulaic, transparent, and objectively constructed. Is it a total market portfolio? Not in a capital asset pricing model context, because it doesn't span all marketable assets equivalent to their weight in the actual market. But no index fits this criterion.

Are the cap-weighted indexes efficient? That is to say, can you improve them by constructing better indexes,

Summary: JUST ONE THING

without taking on more risk? Yes, you can improve upon them, so the cap-weighted indexes are not efficient. The classic indexes are actually not the market, and no commercially viable marker portfolio exists; and even if one did it wouldn't matter, because the capital-asset pricing model is predicated on so many structurally flawed assumptions that the notion that the cap-weighted indexes must be efficient is the same as the notion that the underlying assumptions must be true.

Real Implications

There are very real implications in this model for long-short investing. Large institutions and pension plans will probably move large portions of their equity assets into indexes like this. What is a 2 percent difference worth? Let's assume that, with your current portfolio, in 36 years you end up with \$1 billion. If you can increase portfolio performance by just 2 percent, you will end up with \$2 billion. A 2 percent alpha doubles your cumulative assets over these longer time horizons of pensions.

If you are an individual, the same principle applies. Over 36 years, that 2 percent will double your return. ●

The Outsider Trading Scandal

The Author: *George Gilder is editor of the Gilder Technology Report; chairman of Gilder Publishing, LLC; and a senior fellow at the Discovery Institute.*

The law for information disclosure by public companies and aspirant public companies prohibits the release of materially significant news unless it is published simultaneously to the world. This well-meaning rule is sup-

posed to create a level playing field where no investors have the advantage of inside knowledge. But a level playing field means no information, which is defined as a deformation of the level. Information, like life, is disequilibrium. What the Securities and Exchange Commission accomplishes is to reduce the amount of real information in stock prices.

Less information means increased volatility and more vulnerability to outside events. With the entire field of information about companies a regulated arena, information does not bubble up from firms spontaneously in raw and ambiguous form with executives and engineers freely expressing their views and even investing on the basis of them. It emerges as various forms of processed public relations.

The Investor's Challenge

The key for investors is to ignore the outside noise and focus on acquiring real, fundamental knowledge about companies. The fundamentals will ultimately prevail. Inside knowledge is harder to get under the new regime, but it remains irrepressible.

The Internet is full of sources of competitive analysis and technological expertise. New companies are emerging with powerful ways of obtaining and revealing the crucial troves of inside knowledge that determine the destiny of companies. Some of this information is being made available to the public by vendors such as Gerson-Lehrman with software that enables quick links from investors to hundreds of thousands of available experts. A new generation of information companies, focused on the real sources of value in markets, is creating a new topology of information amid the leveled playing fields of government-enforced ignorance. Watch for these developments and take heed. Skill and information are your remedies for the dismal economics of gamblers' ruin. ●

The Winner's Rule

Successful businessman Michael Masterson writes that there is a way of conducting yourself in business (and other areas of your life) that can give you success, peace of mind, and happiness.

That secret is this: In every relationship you get into — every business, social or personal transaction — make sure that the other person gets as much benefit from it as you do. When considering your own advantages and disadvantages in taking any course of action, consider those of everyone else involved.

Thinking about the other guy first may not be instinctual behavior. But the course of human progress could be said to be the history of our efforts to do just that.

Rich Man, Poor Man

The Author: *Richard Russell has been writing and publishing the Dow Theory Letters since 1958.*

Making money entails much more than predicting which way the stock or bond markets are heading or trying to figure which stock or fund will double over the next few years. For the great majority of investors, making money requires a plan, self-discipline and desire.

The average investor needs to have a financial plan. Here are some rules on investing that should be followed if you are serious about wanting to make money:

Good Advice About the World of Wealth

Michael Masterson offers these pieces of advice:

- Business doesn't happen until you make the first sale.
- The single most effective way of entering a new market is to offer a popular product at a drastically reduced price.
- It's ultimately about selling. Great businesspeople make their fortunes by increasing the perceived value of their products, thus ramping up prices and drastically increasing profit margins.
- When choosing a business, select one that can be grown without your personal involvement. In growing your business, make sure it can expand with the addition of more money, property or people — but not more of you.
- Before you invest in anything, know exactly how much you are willing to lose — and get out if you hit that stop-loss point.
- First improve your strengths. Then, eliminate your weaknesses.
- Focused effort is more effective than a diversified approach to business building.
- Let your winners run and cut your losses short. When the marketplace tells you that your great idea is a loser, don't keep pushing.
- Pareto's Principle (the 80-20 Rule): 80 percent of your success comes from 20 percent of your resources. Most of the success, income and satisfaction you will get in your career will come from a small portion of your skills, projects and efforts.

1. Compounding works. To compound successfully, you need perseverance in order to keep you firmly on the savings path. You need intelligence in order to understand what you are doing and why. You need knowledge of the mathematical tables in order to comprehend the rewards. You need time to allow the power of compounding to work for you.

2. Don't lose money. Most people lose money due to disastrous investments, gambling, rotten business deals, greed, and poor timing.

3. Wealthy people don't need the markets. They already have all the income they need. Money is being generated from bonds, T-bills, money-market funds, stocks, and real estate. They never feel pressured to “make

money” in the market.

4. Look for values. The only time the average investor should stray outside the basic compounding system is when a given market offers outstanding value. This means it offers safety, an attractive return, and a good chance of appreciating in price.

All investing and speculation is basically an exercise in attempting to beat time. Time is the single most valuable asset you can ever have in your investment arsenal.

There is no substitute for acting. In the business of investing or the business of life, thinking is not going to do it for you. Thinking is just rehearsing. You must learn to act. The reasons to act are almost always better than the reasons you can think up not to act. ●

The Millennium Wave

The Author: John Mauldin is a leading expert on investment issues.

We are only halfway through what we call the Information Age, with more profound changes as to how we work and play just around the corner. But this time something is different. Instead of one wave of innovation following another, we are going to see multiple waves of significant change and innovation surge all over the world at roughly the same time. The combined effects are going to produce a period of change unlike anything seen in the history of man. This Millennium Wave will change things in ways that almost defy the imagination and at a pace that will leave one breathless.

Looking at which things will not change will give us some clues as to what will change. There are three things that over the next 40 years are not going to change: the innovation cycle, the business cycle, and human psychology.

Surfing the Millennium Wave

The more precisely you plan your future, the harder that change will hit you. Flexibility will be the order of the day.

The Millennium Wave is also going to offer the greatest investment opportunities ever seen, as whole new companies and processes are created. Taking advantage of all these changes will require nimbleness and an ability to make decisions, rather than passively investing in indexes, which will reflect the companies that have already become large or are ready to go the way of the dinosaurs.

Change. You'd better get to know and love it. It is coming. That is one thing that for certain will not change. ●

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Summary



10 Steps To A Perfect Retirement Portfolio

Live It Up without Outliving Your Money

THE SUMMARY IN BRIEF

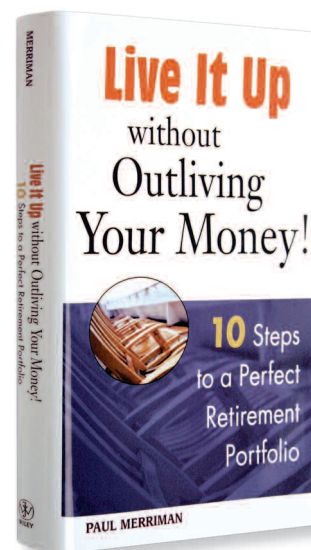
Not so long ago, the most difficult part of retiring was deciding what you were going to do with all your free time. Today, retirement has become more complex than anyone could have ever imagined. Fluctuations in financial markets coupled with the fact that we'll all be living longer, more active retirement lifestyles have many of us asking, "How am I going to pay for my retirement?"

Live It Up without Outliving Your Money! 10 Steps to a Perfect Retirement Portfolio shows you how to create and maintain the perfect retirement portfolio. From determining what assets have the highest probability of giving you the returns you need, to controlling taxes and expenses, the simple strategies outlined within these pages will help you regain confidence in your retirement portfolio.

For four decades, Paul Merriman has helped and watched people manage their money – both before and during retirement. Over the years, working as a hands-on money manager has given him an enormous amount of practical experience with real people in real situations. Merriman distills what he has learned into these pages to help you create a portfolio that will fulfill your unique retirement needs.

IN THIS SUMMARY, YOU WILL LEARN:

- The motivation to get into action and improve your financial situation.
- How to tailor a financial plan for retirement that takes into account the right amount of risk for you.
- Useful tools to keep your emotions from derailing your investments.
- Multiple strategies for withdrawing money once you've retired.
- How to find and hire a financial advisor whose interests are the same as yours.



by Paul Merriman

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THE COMPLETE SUMMARY: LIVING IT UP WITHOUT OUTLIVING YOUR MONEY

by Paul Merriman

The authors: Paul Merriman is President of Merriman Capital Management. He hosts Sound Investing, a weekly radio show broadcast, and is a regular columnist at Marketwatch.com. He is also the publisher and editor of FundAdvice.com, an online newsletter and investment advisory service. Copyright 2005 by Paul Merriman, Inc. Summarized by permission of the publisher, John Wiley & Sons, Inc., Hoboken, New Jersey. 232 pages, \$22.95. 0-471-67997-6.

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PART I: WHY SOME SUCCEED AND MANY FAIL

Why Investors Fail

Investing isn't terribly difficult, but it's a specialized area that requires careful navigation. A huge industry has evolved to use a multitude of clever ways to separate people from part of their retirement savings without necessarily providing them much benefit in return.

Think of investing as a journey. You start at one place and head for another. The best route may be efficient but boring. Investing is about taking risks. But along the way there are hundreds of distractions and opportunities to get you off the track. We'll look here at some of the more serious ways that typical investors work against their own interests. Most investors occasionally take way too much risk. Sometimes they don't take as much risk as they should. Investors pay too much of their hard-earned savings to other people who are not necessarily on their side.

Without getting any particular benefit in return, too many investors give up liquidity, making it costly and inconvenient to get their money back when they need it. They put their money into investments they don't understand, leading to grief, loss and disillusionment that sometimes prompts them to give up altogether. ●

16 Common Traps:

Mistake No. 1: No written plan

People with written plans for their investments wind up with much more money during retirement than those who don't have written plans. This document should spell out your main assumptions about inflation, future investment returns, how much you'll save before

you retire, when you will retire, the amount of money you'll count on from fixed sources such as pensions, Social Security, and perhaps part-time employment, as well as the amount you'll need to withdraw from your portfolio in retirement. Your written plan should specify how you will make asset allocation choices and where you'll get professional help when you need it.

Mistake No. 2: Procrastination

If you wait for the "right time" to get your investments organized or reorganized, the wait could ruin your results over a lifetime. The longer you wait, the less time you'll have. Time is an investor's best friend.

Mistake No. 3: Taking too much risk

People who take too much risk often wind up being speculators rather than investors. Savvy investors, on the other hand, pay a lot of attention to limiting and managing risks.

Mistake No. 4: Taking too little risk

Some people are paranoid about losing any money at all. If you're saving for retirement 25 years down the road, and you opt for a very conservative mix of investments that is expected to return 7 percent annually instead of an all-equity portfolio with an expected annual return of 12 percent, you may be massively short-changing yourself.

Mistake No. 5: Trusting institutions

You and your bank have a classic conflict-of-interest. Your best interests are served by an account that pays the highest interest along with penalty-free access. Your bank's best interests are served by accounts that pay you little or no interest.

Mistake No. 6: Believing the media

Serious investors need textbooks more than hot ideas.



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Rebecca S. Clement, Publisher; Sarah T. Dayton, Managing Editor; Joanne Merenda, Graphic Designer; Bernard Shire, Contributing Editor

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But most people would rather have entertainment, and that's what broadcast outlets and financial publications provide. The purpose of the articles is to get you to buy the publications.

Mistake No. 7: Failing to take small steps that can make big differences

Far too many people fail to make their IRA contributions at the start of the calendar year. Others leave money in taxable accounts instead of sheltering it in retirement accounts. Each of these steps seem small by itself. Yet over a lifetime they can make a big difference – but only to people who act.

Mistake No. 8: Buying illiquid financial products

Liquidity is severely compromised when you invest in limited partnerships, for which there is often no market. Liquidity is also impaired with variable annuities and load mutual funds.

Mistake No. 9: Requiring perfection in order to be satisfied

People who can't stand to have anything but "the best" solution seldom make successful investors. Perfectionists often flit from one thing to the next, chasing elusive performance. In real life, you get a premium for risk only if you stay the course.

Mistake No. 10: Accepting investment advice and referrals from amateurs

Too many people make financial decisions based on things they hear casually. But as painful as it is, there are no safe shortcuts to wealth.

Mistake No. 11: Letting emotions drive investment decisions

The desire to make money is legitimate. But unless it is tempered with a healthy respect for risk, it turns into greed. Likewise, the desire to avoid or limit losses is legitimate. But when it is allowed to run amok, it turns into fear.

Mistake No. 12: Putting too much faith in short-term performance

Many investors, especially inexperienced ones, spend far too much time and energy trying to forecast what essentially cannot be forecasted: short-term performance.

Mistake No. 13: Overconfidence

Many overconfident investors put too much of their money into a single stock or single fund. Then they get emotionally attached and their attachment takes on a life of its own. By the time such an investor is willing to

Ten Steps To A Perfect Retirement:

Step 1: Determine how much you will need to live on in retirement.

Step 2: Determine how much you want to live on in retirement.

Step 3: Determine your tolerance for taking risks.

Step 4: Make all your decisions based on what's probable, not what's possible.

Step 5: Determine the kind of assets that will give you the returns you need to achieve your goals.

Step 6: Combine those assets in the right proportions into a portfolio that's tailored specifically for you.

Step 7: Learn to recognize and control the expenses of investing.

Step 8: Make sure you understand enough about the tax laws to avoid giving Uncle Sam a bigger-than-necessary cut of your money.

Step 9: Establish the right distribution plan that will give you the income you need in retirement along with the peace of mind of knowing you won't run out of money.

Step 10: Put everything you do on automatic pilot.

admit that things have changed, he or she will probably have stayed much too long.

Mistake No. 14: Focusing on the wrong things

It's generally accepted that asset allocation accounts for more than 90 percent of investors' returns. That leaves less than 10 percent for choosing specific stocks and mutual funds – the very thing on which most investors spend almost all their time and energy.

Mistake No. 15: Needing proof before making a decision

The ultimate stalling tactic for investors who aren't ready to make a move is to require one more piece of information or evidence. You can get evidence for just about any view of the market you want, but you cannot get proof.

Mistake No. 16: Not knowing how to deal with the first 15 mistakes

The cure for all these mistakes may seem obvious, but they are not necessarily easy:

- **Make sure you have a written investment plan.**
- **Educate yourself.**
- **If you don't understand an investment, don't put your money in it.**

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- Sometimes the best course may be to simply slow down.
 - If you notice that emotions are driving your decisions, substitute a discipline.
 - In the end, the best one-word prescription for avoiding most mistakes is diversification. ●
-

Lessons from Smart People

Successful retirement requires something more than just raw financial numbers. Smart people take a thoughtful, long-term approach to their lives.

Smart Step 1

Smart people make plans for their retirement, financial and otherwise, and they put those plans in writing.

Smart Step 2

Smart people, before and during retirement, don't spend much of their time on the proverbial porch rocking in the proverbial chair. Instead, they keep themselves active and challenged, both mentally and physically.

Smart Step 3

Smart people cultivate new relationships and nurture their established ones with friends, family and colleagues.

Smart Step 4

Smart people have lots to live for. They wouldn't have any trouble making a list of two dozen things they would like to do if they had time.

Smart Step 5

Smart investors and retirees pay attention to their money and treat it as if it were precious.

Smart Step 6

Smart people don't wait for luck to make them wealthy. Instead, they cultivate habits and attitudes that improve the odds of their success.

Smart Step 7

Smart people who are planning retirement don't short-change themselves and their futures.

Smart Step 8

Smart people don't burden themselves with a heap of consumer debt.

Smart Step 9

Smart people know the value of time, and they don't wait until the last minute to start planning for retirement.

Smart Step 10

Smart people who have waited too long don't try to play catch-up by investing in high-risk ventures that rely on luck to make up for lost time. Instead, they find ways to save more and scale back their retirement needs.

Smart Step 11

Smart people learn from the mistakes of other people so they don't have to repeat them.

Smart Step 12

Smart people don't wait for retirement to start making their dreams come true. ●

The Psychology of Successful Investing

It's relatively easy to prescribe an investment plan that is likely to work well if it's followed diligently. The hard part is keeping yourself from derailing your own plans. There's no way to get around one very basic truth about investing: the way to make money is to buy low and sell high. But our emotions, by trying to bring us comfort, work against us, and try to persuade us to do the opposite. Throughout your life as an investor, you will be goaded by the media, which will do its best to keep stimulating you with entertainment that's carefully disguised to look like insight and advice. To be a successful investor, you'll have to figure out how to deal with all that.

The primary goal of the investment industry is to get you to change whatever you're doing. That's how Wall Street makes money.

You need to be a good defensive investor, and must watch out for three things: your own emotions, the manipulations of Wall Street, and the misleading media. ●

PART II: YOU CAN WIN THE RETIREMENT GAME

Who Are You and What Are Your Goals?

To get a good handle on your own circumstances, your first task is to establish your base target of how much money you will need to live on during retirement. The word "need" is critical. You want to cover your essential needs including food, clothing, shelter and medical care. You should also include your utilities and personal care and enough for a modest level of gifts, entertainment, and hobbies. And don't forget to include taxes.

Your second task is to compute a second figure, a live-it-up

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target annual retirement income, to cover discretionary expenses that you can cut if necessary. Travel, a second home, hobbies, and other activities become part of this number. If your live-it-up target is 1.5 to 2 times the size of your basic target, you're probably within the range of reality.

Once you have determined these two numbers, you can figure out how much retirement income must come from your investments to reach each of these targets.

Your base target will determine whether and when you can afford to retire. Until you have enough assets (along with other sources of income) to give you this income, you'll need to keep accumulating savings.

If you repeat the analysis once a year or so, and you adjust your base target and your live-it-up target accordingly, you'll be miles ahead of most investors. ●

Your Perfect Portfolio

The goal is to give you a piece of the action along with peace of mind. What investors need is a strategy with enough power in good times to generate positive returns, coupled with enough protection in bad times to keep them from bailing out in discouragement.

Pension funds of most large U.S. companies use a model of 60 percent to stocks and 40 percent to bonds, with risks tame enough to meet the need of most long-term investors.

Our goal is a plan that will provide higher returns and lower risks than the pension fund model, using no-load funds readily available to ordinary investors. The key is smart diversification. The portfolio includes value, growth, small-cap, large-cap and international stocks.

Your Perfect Portfolio combines multiple asset classes, with higher risk than the S&P 500 Index, yet when combined properly, individual risk offsets each other and produces a lower composite risk figure.

Smart diversification lets you mix two assets together and achieve a higher return, with less risk, than the average return of those two assets. The assets must behave differently from each other which is the key to making your money work hard for you while staying within your risk tolerance. ●

Why Size Really Does Matter

If you want your retirement savings to work hard for you, there are three main changes you must make in the equity part of the standard pension fund's portfolio:

1) Expand the asset mix to include stocks of smaller companies.

2) Include "value" companies that are out of favor.

3) Include international companies.

Small companies have historically produced bigger returns and you can easily and efficiently capture them.

The prudent way to benefit from small company returns is not to invest in individual stocks but in small company stocks as an asset class. These returns can best be captured through mutual funds that invest in the whole asset class, not just a few small-cap stocks. Index funds are the most efficient vehicle for this. Investors should own both large-cap and small-cap stocks in roughly equal amounts.

Over very long periods of time, small-cap stocks have shown a distinct advantage. In general, investors get paid for taking risks, and small-cap stocks can be riskier than large-cap ones, because they are newer companies, with fewer products, less depth of management, and higher costs of capital. ●

Value: Owning What Others Don't Want

One of the most fundamental mistakes investors make is paying high prices for popular assets. You should invest in stocks that other investors don't want, like a good shopper, stocks whose prices may have been going down instead of up. An important part of what investors need is always on sale. Virtually all the famous investment managers of the past 50 years (Warren Buffett, Peter Lynch, Ben Graham, and Bill Miller) made their marks by investing in value stocks.

If you believe in buying low and selling high, then you'll have to be willing to take opportunities to buy assets when their prices are low.

Use a mechanical approach by identifying the largest 50 percent of stocks traded on the New York Stock Exchange and all other public companies of similar size, based on their market capitalization. The top 30 percent are classified as growth companies. But much research shows that historically, unpopular (value) stocks outperform popular (growth) ones. But in six out of 10 possible one-year periods, value stocks were sometimes far, far behind. This is why it makes good sense to include growth and value stocks in your portfolio. ●

Putting the World to Work for You

International Funds

A recurring piece of nonsense that's taught to many investors is that they can get all the investment performance they'll ever need or want from companies based

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in the United States. Only about half of the world's stock market value resides in companies based in the United States. Investors should diversify, that's the most fundamental piece of investment advice.

Stocks of companies outside the U.S. don't always outperform those of U.S. companies. But there are years — and multiyear periods — in which U.S. stocks take a back seat to international ones. Even if international stocks do not outperform their U.S. counterparts, they provide a frequently overlooked but intensely valuable diversification benefit. International stocks can make the difference between a retirement portfolio that lasts a lifetime and one that runs out of money.

Many people are wary of investing outside the United States, partly from fear of the unknown. Internationals reduce risk when combined with U.S. stocks. A 50/50 mix of U.S. and international equity funds is an excellent choice for most investors. But mutual funds containing both U.S. and international stocks aren't a good substitute for international funds. By keeping a significant percentage of their assets in U.S. equities, they won't give investors the international diversification they need.

International funds help prevent volatility. This is based on four points:

1. The biggest risk retirees face is running out of money prematurely.
2. A portfolio that's being asked to support regular withdrawals — withdrawals that increase to keep up with inflation — has very different needs than a portfolio that's merely trying to accumulate assets.
3. Stability is critical in keeping such a portfolio alive for many years.
4. International stocks provide the stability that can make that difference.

Emerging Market Funds

Emerging markets represent the great growth potential of young economies. There are two ways to tame the high volatility of emerging markets — by using no-load mutual funds that diversify widely instead of concentrating on a single region, and by limiting these funds to no more than 10 percent of the equity part of a portfolio. ●

Controlling Risks

Risk is a topic that needs to be brought up again and again. There's no perfect way to know in advance what level of loss you can tolerate, but there are numerous ways to help you get a handle on it.

Ultimately it's necessary to get specific about making the trade-offs between risk and expected return. Risk tolerance has a large emotional component. When you're dreaming of a pleasant and prosperous retirement, it's easy to gloss over the fact that you could fairly easily lose half your money if you make the wrong investments.

You may have more than a single pot of money with only one level of tolerance for risk. And while most people don't want to lose half or more of their money, many people own individual stocks and don't understand the level of the risk they have been taking.

Most people say they are pleased with past investments because they made money, not because their investments had low risk. People are not pleased by past investments that either lost money or made much less than they "should have." The most accurate indicator of your actual risk tolerance is probably what you will do in the face of adversity.

How Reliable Are Stocks?

It's easy to see that stocks are more risky than fixed-income investments, and that much of the time they provide higher returns. But just how reliable is this premium return? And how long must an investor wait to be sure of getting it? Those are excellent questions. Investors who know the answers will have a real advantage over those who don't.

Investors have every reason to expect that stock investments will continue to provide premium returns over the long term. But over shorter periods, this won't always be the case. You should expect to see occasional multiyear periods when cash outperforms stocks (think of 2000 through 2002).

A study that included thousands of computer trials using actual market data from 1926 through 2004 gives some useful insight on the size and reliability of the equity market premium. The study compares the returns of the S&P 500 Index to that of no-risk Treasury bills.

In the very best one-year period, if T-bills returned 5 percent, stocks returned 168 percent. In the worst period, stocks suffered a very sharp loss, equal to 68.9 percentage points below the return of T-bills.

The most important number is "reliability." It indicates that in any 12 consecutive months, investors in equities had about two chances out of three of exceeding the return of T-bills. The reliability factor increased until it reached 100 percent in periods of 20 years and longer. The average premium also increased rapidly with time.

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How Would You

Characterize Yourself as an Investor?

On a scale of 1 to 10, with 1 being extremely conservative and 10 extremely aggressive, people who rate themselves 7 and above usually believe they are able to accept quite a bit of risk. Often the answer to this question is inconsistent with other answers. Never ignore your emotions or your “better judgment” in order to chase higher returns. In the end, peace of mind is priceless. ●

Meet Your Enemies: Expenses and Taxes

Investors leave money on the table in many ways. They invest in tax-inefficient funds. They trade too often. They fail to take full advantage of tax-sheltered accounts such as IRAs and 401(k)s. The IRS reports that in 2000, fewer than 10 percent of the taxpayers who were eligible to contribute to an IRA did so.

Advice: When you can, stack the odds in your favor by using low-cost index funds. Example: The popular Legg Mason Value Primary Fund charges 1.7 percent, twice as much expense ratio as the Fidelity Magellan Funds 0.7 per year. This is a leak.

In money market funds, the Vanguard fund kept 20 percent of the portfolio's return for itself, giving shareholders 80 cents on the dollar, compared to the Alliance Bernstein fund keeping 63 percent for itself, leaving only 37 cents on the dollar for shareholders. This is a leak.

When you invest \$10,000 in a no-load fund, the entire \$10,000 is invested on your behalf and goes to work for you. In a load fund, a sales commission is subtracted from your investment. Invest \$10,000 in a fund with a 5.75 percent front-end load and only \$9,425 is invested for you. There is no statistically significant difference in the returns of all load funds and all no-load funds – assuming that you ignore the load.

Avoid variable annuities: a lethal combination of too-high expenses and too-high taxes. ●

Putting Your Perfect Portfolio to Work

Where should you put your money so you get what you need?

- Exchange traded funds.
- T. Rowe Price is a venerable and respected no-load fund family known for conservative management, wide diversification, and reasonable expenses.

- Fidelity is the powerhouse of 401(k) plans, and millions of employees depend on Fidelity funds for important parts of their retirement savings.
 - For many years, the low-cost, tax-efficient index funds of Vanguard were favored for do-it-yourself investors. Unfortunately Vanguard in 2004 closed its International Explorer Fund (VINEX) to new accounts, locking new investors out of two important asset classes.
 - Some investors may wish to use Charles Schwab's brokerage, which offers convenient access to many funds from many families.
 - For investors who don't want to compromise on asset classes, look at the Merriman model portfolio. This group of no-load funds is the best bet for do-it-yourself investors who are willing to go anywhere and who accept the inconvenience of multiple fund families and statements.
 - The best way I've found to build a portfolio is using the no-load asset-class funds offered by Dimensional Fund Advisors (DFA). ●
-

Withdrawals: When Your Portfolio Starts Paying You

The biggest financial risk that retirees face is running out of money before they run out of life. How you structure your withdrawals plays a major role in this.

Most retirees pay too little attention to how they will take money out of their portfolios. The critical question is how much of a portfolio you can or should tap on an annual basis.

You should start retirement with savings equal to 20 times the amount you'll need from your portfolio every year. That implies a withdrawal rate of 5 percent.

A 6 percent withdrawal rate is considered “conservative” and it is generally in tune with meeting the basic target income; an 8 percent withdrawal rate is more suitable for retirees with more money than they'll ever need.

No matter how much money you have, no rate of withdrawal can be sustained continually from a portfolio that's invested in the wrong assets.

As the withdrawals go up every year, they take an increasing bite out of the portfolio. The most important thing to look at is the value of the portfolio from year to year. This is the crucial measure of whether a retiree is in any danger of running out of money.

Retirees, whether they're on relatively tight budgets or not, need to find the right balance between security and

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the freedom to “live it up” by spending money they can afford to spend. Most people will find that balance in a variable withdrawal schedule based on their actual portfolio performance each year.

Real-life situations almost always require more than formulas. The emotional and psychological hurdles can be more formidable than the strictly financial ones. ●

Hiring an Investment Adviser

Based on a national survey, investors with advisers were nearly three times as likely to expect a comfortable retirement as those without advisers.

The bad news is that every year, millions of investors get poor advice and some of them get fleeced, from brokers who don't have the training, the experience, the knowledge, or the incentives to give investors the help they need. The good news is that the fastest-growing segment of the financial services industry is made up of independent advisers. Investors who are willing to do their homework and who know what to look for can find excellent advisers whose interests match those of their clients.

To avoid conflicts of interest, at the heart of compensation is a question: Who's paying the adviser? To put it bluntly, an adviser whose compensation comes from an insurance company, a mutual fund company, a brokerage house, or any other financial services company is not working for you. An adviser whose compensation comes exclusively from clients is working for those clients.

Compensation comes in four forms:

1. Your adviser can be paid on commissions generated when you make transactions.
2. In a fee-only arrangement, you may pay the adviser by the hour, or a flat fee for specified services.
3. In a different fee-only arrangement, your adviser may be paid a small percentage of your assets periodically.
4. There are incentive compensation programs that are legal only for accredited investors.

When you're shopping for a financial adviser, look for experience; lots of knowledge about expenses, taxes, diversification, asset allocation, withdrawals, and risk management; a commitment to avoid conflicts of interest; a commitment to be available whenever you need something; and someone who will listen to you and take you seriously when you aren't happy. ●

Your Action Plan

The most important decision investors must make is their choice of assets. The second most important decision

and the toughest is to make a change. Here is a list of the essential steps that you should take:

- Make a balance sheet that shows your assets and liabilities.
- Review your investments to make sure your overall asset allocation includes all parts of your portfolio.
- Use the Instant X-Ray portfolio analysis tool at Morningstar.com to analyze your investments.
- Break down your portfolio by taxable and tax-sheltered accounts.
- Make a written retirement plan.
- Analyze your spending.
- Hire an adviser.
- Meet with your spouse or partner to discuss goals.
- Educate yourself.
- Once each year, remind yourself of your three biggest adversaries: Wall Street, the media and your own emotions.
- If your will doesn't do what you want, meet with your attorney to write a new one.
- Meet with your adviser to write an investment policy statement.
- Sell any investments in the wrong asset classes.
- Sell investments saddling you with excessive taxes.
- Establish an automatic investment plan.
- Schedule one day a year to rebalance your portfolio.
- If in or near retirement, review withdrawal plan.

It is never the wrong time to do the right thing. But it is always the wrong time to keep doing the wrong thing. ●

My 500-Year Plan

If you have surplus funds left when you complete your life, there's estate planning.

I have devised a 500-year plan for my money. The overall plan is to leave money in a way that will supplement my family's own income, and my estate plan will ultimately provide continuing support to charitable causes.

My estate will create a charitable remainder trust for each of our children. Each year, the trustee will tally up the assets in each trust and pay 5 percent of the total to the beneficiary.

At the end of the lifetime of each of the children, the assets in each trust will go to the Seattle Foundation which will invest the money. Each year it will pay 5 percent of the money to charities my wife and I have designated.

This is a permanent arrangement and hence, my 500-year plan could theoretically last much longer than that! ●

· Book 27 of 44 ·

Summary

How to Profit When Stocks Advance, Stocks Decline, Inflation Runs Rampant, Prices Fall, Oil Prices Hit the Roof ... And Every Time in Between Opportunity Investing

THE SUMMARY IN BRIEF

In *Opportunity Investing*, Gerald Appel, world-famous author and lecturer, shares his insights for spotting opportunities in the financial markets and integrates techniques of both technical and fundamental analysis. Through his own research and trading firm, he has tested his methods, and they work. They work under varying market conditions and economic climates, actually working with — rather than despite — those variations.

Appel has something to say to the experienced and the novice investor. His methods rely on the sense he has developed over his years of observing, researching and tracking financial markets, but he looks to the future, keenly aware of the challenges posed by tomorrow's markets in our rapidly changing global economy.

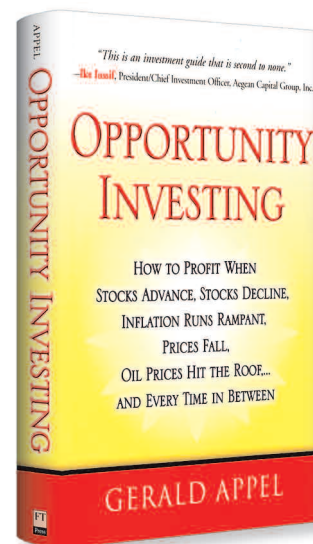
Opportunities lie within and outside the United States, and, besides the usual, — stocks, bonds, mutual funds, and money market instruments — Appel also looks into less familiar areas such as commodities, overseas bonds, foreign stocks, real estate-related instruments and investments in developing countries. He suggests ways to time purchases and sales, and how to create well-diversified and balanced portfolios that fit your stage of life and financial situation.

Strategies in this book cover a wide range of approaches to opportunities in the markets: timing strategies, selection strategies, diversification strategies and risk-reduction strategies across market segments, used in isolation or simultaneously.

We live in a world of change and challenges, and as *Opportunity Investing* suggests, it is also a world of opportunity.

IN THIS SUMMARY, YOU WILL LEARN:

- The weaknesses of the conventional “buy and hold” wisdom.
- How to diversify to get a truly diverse portfolio.
- How to select investments within an asset class.
- How to use basic tracking techniques to read market signals.
- How to prosper with inflation — or deflation.
- How to invest in newer vehicles: ETFs, REITs, etc.



by Gerald Appel

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THE COMPLETE SUMMARY: OPPORTUNITY INVESTING

by Gerald Appel

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The Myth of Buy and Hold

Regardless of what Wall Street and the mutual fund industry would have you believe, there are considerable risks to buying and holding stocks, even for long-term investors.

Inasmuch as the progress of stock prices tends to reflect economic growth, for example, investors who limit themselves to just the U.S. stock market may be placing themselves in a position from which it will be difficult to achieve the rates of capital growth required for expenses later in life.

You do not have to be an expert in every area of opportunity. But you should be familiar with at least a sufficient number of investment markets to be able to maintain diversified, flexible portfolios in a variety of investment sectors. You should be familiar enough with the behavior of the various markets in which you invest to be able to create and maintain exit strategies for when the time comes to cash in.

Successful market timing, like well-considered diversification, can help you to both increase returns from your investments and to reduce risks associated with buy and hold investments. ●

Putting Together A Winning Portfolio

Often, the typical portfolio has been gradually assembled over diverse market climates, influenced by fads, and possibly cluttered with losing investments. Relatively few investors operate with balanced, thought-through investment portfolios that actually match good principles of capital management, which involve two

major issues: the average rates of return over the years, and the amount of risk along the way. Returns are likely to be more consistent for investors who maintain balanced portfolios, who diversify.

Mutual funds provide excellent vehicles for diversification; they provide a means of establishing well-diversified portfolios representing many asset classes with limited amounts of capital. A portfolio of mutual funds representing diverse investments may be readily rebalanced, reapportioned and adjusted in accordance with a changing market.

Rebalancing the portfolio improves returns: Ride the lead horse until you see it tiring, then jump onto the next lead horse. ●

Selecting Mutual Funds Most Likely To Succeed

Watch out for ratings — where all the mutual funds are "above average" — and for hidden fees. Not only are lower expense ratios indicative of funds that are cheaper to own, but they also perform better than "loaded" funds. The lower the fund volatility, the better; but with excellent market timing, some higher-volatility vehicles might prove advantageous. Continuity of management is important in an actively managed fund.

The Triple Period Selection (TPS) strategy represents a simple screening strategy designed to identify mutual funds with a long-term history of consistently outperforming the S&P's 500 Index while involving less risk. Performance criteria require that the mutual fund's performance over the most recent three-, five- and 10-year periods must have surpassed the annual performance of



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the S&P 500 index, including dividends.

The Sharpe ratio can measure risk-adjusted performance. Have your investment returns been worth the risk? Has the gain been worth the pain? The Sharpe ratio criteria of the mutual fund must have been at least 0.75 for the most recent three-, five- and 10-year periods. The formula that creates the basis for the Sharpe ratio is: $\text{Monthly Sharpe Ratio} = \frac{\text{Average Monthly Return} - \text{Monthly Risk-Free Return}}{\text{Monthly Standard Deviation of Returns}}$. Fortunately, you do not have to do the math, Sharpe ratios can be found on www.Morningstar.com, www.Yahoo.com under financial and in the financial areas of www.MSN.com.

Managing Your Buy and Hold Portfolio

Even the best of funds may lose strength relative to the market as a whole and/or to other mutual funds.

Review your portfolio annually to ensure that your holdings continue to meet the basic criteria required for long-term investment positions. For taxable positions, the holding period should be at least one year because a one-year holding period is required to qualify an investment for long-term capital gain tax treatment.

Sell holdings that no longer meet buy and hold criteria and replace them with new qualifying positions, avoiding “loaded” funds that incur front-end loads or back-end charges for holding periods longer than one year.

Apply the concepts of diversification; you might select a real estate, a small-cap value, a global income, an asset allocation and an all-cap mutual fund for a five-fund diversification.

For most investors, this segment of your investment portfolio may occupy about 35 to 50 percent of your stock market investment assets, representing a fine, tax-favored core position in your total portfolio.

Putting Together and Maintaining a Portfolio of Strong Mutual Funds for Intermediate-Term Investment

You can benefit from identifying and investing in mutual funds that outperform 90 percent of other mutual funds for somewhat shorter periods of time, shifting assets so your capital starts each investment period in funds representing the top 10 percent of mutual funds in terms of market strength.

Intermediate-term investing offers more gain, less pain; it's responsive to changing market leadership; and there are relatively few transactions each year. A mutual fund is defined as a market leader if its performance over the

most-recent three months has been in the top 10 percent of all mutual funds. The four-step “follow the leader” strategy has shown excellent past performance:

1. Identify the leaders.
2. Buy the leaders.
3. Hold the leaders until they stop leading.
4. Change to new leadership.

There are almost perfect correlations among performance, risk levels and decile rank. You can up the ante with the “Double Time Ranking” model by using the past 3-month's plus the past 12-month's return to rank funds, using only those funds in the top decile of performance, with lower than average volatility and no load. Be sure to rank and rebalance quarterly. ●

Income Investing — Safer and Steady ... But ...

A bond is a loan that a bondholder makes to a corporation, or to the government or another organization, for which the borrower agrees to pay a certain amount of interest. You know how much you are investing, how much interest you are scheduled to receive and when you are supposed to get your money back. So far, so good ...

What are the risks? Default risk is when a borrower fails to meet its interest payments or cannot repay its bond's face value. Even well-known companies and large municipalities have defaulted. Only bonds issued by the U.S. government are considered to be free of default risk.

The creditworthiness of the issuers of bonds sorts is rated by five major rating agencies. The ratings broadly divide bonds into two categories: investment grade and non-investment grade. For safety purposes, bond investments should be confined, for the most, part to investment grade holdings. Risks can also be contained in a bond portfolio through diversification. Shorter maturity bonds carry less risk than longer-term bonds.

The length of time until the maturity of a bond is one factor in the risk involved in that bond, another measure of risk is bond duration. The difference is a bond's maturity tells you when you will receive full repayment of the bond's face value. A bond's duration is a weighted measure of when you will get your investment back from a bond investment, including the stream of interest payments that you receive during the time that you hold these bonds. The lower the duration of the bond, the less risk. For bonds with the same maturity, the bond that

pays the higher rate of interest each year has the lower duration, or lower risk.

Bond Mutual Funds vs. Individual Bonds

The advantages of bond mutual funds include:

Ready diversification: Bond mutual funds can provide, at reasonable cost, a higher level of bond diversification for smaller investors.

Specialized portfolio management: There are areas of bond investment about which the typical investor is likely to be unfamiliar that could represent convenient vehicles for investors to expand their investment opportunities.

Investing in small increments: Many bond mutual funds enable investors to initiate and to supplement existing bond portfolios with relatively small amounts of capital. Additionally, bond mutual funds generally allow investors to automatically reinvest interest from exiting bond holdings in additional mutual fund shares as such interest is paid providing a ready ability to compound income from your holdings.

Simplified record-keeping: Mutual funds keep track of your dividend (actually interest) payments for tax purposes and provide year-end reports.

It is more convenient to invest in bonds by way of mutual funds, but not necessarily more profitable and not necessarily safer. The advantages of portfolios of individual bonds are:

A specific maturity date: Bond mutual funds have no such date of maturity for their portfolio.

Diminished risk as its holdings draw closer to maturity: This is a quality that does not generally exist in bond mutual funds.

More closely tailored to the life situation of the investor: The expenses of maintaining a portfolio of individual bonds are likely to be less than the costs of a portfolio of bonds based in mutual funds. ●

Securing Junk Bond Yields at Treasury Bond Risks

High-yield bond funds represent a sector of interest even on a buy-and-hold basis. However, with its higher volatility, this sector can perform even better when managed with timing models that involve relatively infrequent trading. The 1.25/0.50 timing model is an example of a “market-reversal timing system.” Reversal timing systems are based on the premise that when a market, or in this case a bond fund, has moved by a certain amount

Bonds and Bond Funds for All Seasons

- U.S. Treasury bills are the safest and very liquid but do not provide much return.
- Short-term bonds (and bond funds) provide relatively high levels of safety, liquidity and slightly higher returns. Prices do fluctuate, but they provide safe havens for capital during bear markets.
- Intermediate-term bonds (and bond funds) provide considerably more safety than long-term bonds, with 80-90% of the return; they are very useful for laddering maturities.
- Long-term bonds (or bond funds) may be suitable for pension portfolios, for which they provide prudence and predictability. However, long-term bonds are more susceptible to declines created by rising interest rates.
- Treasury Inflation Protected Securities (TIPS) are U.S. Treasury bonds, guaranteed to provide total income and return of principal that exceed the rate of inflation. These should be used in a tax-sheltered portfolio, such as a retirement account, as they can create hidden tax consequences for investors.
- Zero-coupon bonds are bonds that pay no interest while they are maturing, instead the total return is paid at maturity. The price of zeros, therefore, is deeply discounted, making them a relatively cheap investment. Zeros are much more volatile than other bonds, however, and have a serious tax disadvantage, in that investors must pay tax on the implied (although not paid) interest each year. Zeros probably are best held in tax-sheltered portfolios.
- Municipal bonds provide income that is exempt from federal taxes and usually from local taxes if the investor resides in that locality. Though the yield is slightly less than that of bonds with equal maturity and risk, the after-tax return is usually as good or better for high-income (and highly-taxed) investors. “Munis” should never be used in tax-sheltered portfolios.
- High-yield bonds (or bond funds) are higher risk corporate bonds. During periods of economic weakness (which result in high investor pessimism), high-yield bond funds have provided yields that have been considerably higher than other bonds, surpassing the 10-year U.S. Treasury note by 6 percentage points or more. Conversely, during periods of economic strength, yield spreads tend to narrow.

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in a direction opposite a trend in motion, the presumption can be made that the trend is no longer in effect and that a reversal in trend is taking place. The timing model will generate “signals.”

1.25/0.50 Timing Model Signals

- **Buy signal:** A rise in price of 1.25 percent from the lowest price level since the last sell signal, means the end of a downturn (buy!).
- **Sell signal:** A drop in price of 0.50 percent from the highest price level since the last buy signal means the end of an uptrend (sell!).
- **Signal failure:** It is unrealistic to expect every signal to be profitable. The key is to recognize failure and to reverse strategy immediately.

The 1.25/0.50 timing model is based on procedures that take into account the total returns of high-yield bond funds. The total return of a bond fund is the net gain or loss created by a combination of the price movement of these instruments and the dividend flow that investors receive.

Generally, investments of higher volatility benefit more from the application of effective timing models than investments of lower volatility, because timing models tend to produce greater reductions in risk for more volatile investments.

The Wonderful World of Exchange-Traded Funds

Attempts have been made over the years to develop investment vehicles that would provide internal diversification, ready liquidity and be tradable at low cost at any time of the market day with no restriction.

Unlike mutual funds, and like stocks, Exchange-Traded Funds (ETFs) are traded on various stock exchanges and over the counter. Markets for an increasing number of ETFs have become liquid enough for active trading at fairly narrow spreads. There are ETFs available for just about every taste and speculative level of investor.

The advantages of ETFs are:

- Diversification — many different stocks in one investment vehicle.
- Lower management costs than for traditional mutual funds.
- More favorable tax treatment — capital gains distributions are a lower percentage of assets.
- Liquidity and visibility — may be traded whenever the market is open.
- Asset allocation and portfolio control —

no restrictions on active portfolio management strategies.

The disadvantages of ETFs are:

- Transaction costs and bid-ask spreads — ETFs involve brokerage commissions for purchase and sale; bid-ask spreads are potentially costly for less liquid ETFs.
- Trades may vary from net asset value.
- Some ETFs lack diversification — may hold only a relatively small number of highly liquid stock issues of a certain index rather than the full index.
- ETFs provide good indexing but no management panache.

Do not be afraid to think out of the box! ETFs have been creatively managed, represent a broad array of investment possibility, have been sufficiently liquid and allow for shifting investment to meet shifting market climates. ETFs do indeed qualify as opportunity investments! ●

A Three-Pronged Approach to Timing the Markets

Use price/earnings patterns to locate the best times to enter the stock market. Relationships between earnings trends and the price movement of the stock market are not precise over the short-term but are actually quite consistent over the long-term. Sometimes prices move ahead of earnings. Sometimes earnings move ahead of prices. The best buying opportunities have occurred during periods when earnings growth has moved well above price growth. The stock market has been most favorable when price/earnings ratios have declined to 9.3 or below.

Conversely, the stock market has performed worst when prices have advanced ahead of profits. Stocks have, historically, been expensive and on treacherous ground when price/earnings ratios have risen above 20.2.

Price/earnings ratios have risen over time — investors have been willing to pay more for stocks over the years. Corporate earnings, however, do not exist in a vacuum.

Use bond yields to know when to buy stocks. Buy stocks when they are cheap relative to bonds. The stock market generally performs best during periods of rising bond prices and declining interest rates. Rising interest rates tend to exert negative impacts on business, and so stock prices tend to fall. Also, as interest rates rise, why buy stocks when bonds may be providing greater rates of return? Stocks tend to achieve their best gains

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when they are undervalued in comparison to bonds based on relative yields.

Earnings yield is earnings per share relative to price per share.

The greater the bond yield compared to the (stock) earnings yield, the lower the rates of gain in the stock market. The best time to own stocks is when bond yields are equal to or slightly above forward earnings projections (analyst estimates of the next 12-months' earnings) for the S&P 500 Index. Use these periods to accumulate stock.

Buy stocks when earnings news is bad; sell when earnings news is best. The best earnings gains on a year-to-year basis tend to accompany lackluster periods for stocks. Poorer earnings comparisons tend to be better news for stocks. The stock market, in price movements, tends to discount future events — changing direction between six and nine months before significant changes in the direction of the economy. Savvy investors look ahead.

Do not become lulled into a sense of security just because the media is trumpeting news of very favorable year-to-year growth in corporate profits. The stock market is usually a safer buy just as declining trends in earnings are ameliorating. The best gains take place in anticipation of earnings growth rather than in reaction to it. ●

Time Cycles, Market Breadth, Bottom-Finding Strategies

For whatever reason, the stock market does appear to rise and fall with certain cyclical short- and long-term regularities. Time cycles are measured from low point to low point.

Whether by accident or political design, there have been close correlations between the four-year presidential election cycle and the stock market's four-year cycle. The market tends to initiate bull markets as the second half of the presidential term gets underway, rise strongly during the president's third year in office, rise more gradually the next year (the election year), show much more moderate gains in the first year of the new presidential term, and sharply decline in the second year of the new term.

Many articles and studies have been published detailing strategies for taking advantage of the presidential election cycle. As a general rule, think toward stock accumulation early in the four-year cycle, and also very late in the cycle as the market moves toward its final cyclical lows.

Market Breadth

All stocks are not equal in the ongoing calculation of levels of the S&P 500 Index (or the NYSE Index or the NASDAQ Composite Index). The index is weighted by capitalization, so that prices of larger companies have more effect on the index than the prices of smaller companies.

This means that even if only a small number of shares are up for the day, the index may be up for the day, even though most companies listed on that index showed a decline. Although the major market indices' price movements do often reflect the behavior of the typical stock, there are times when the major market indices do not reflect the behavior of the typical stock or the experience of the typical investor.

Breadth indicators reflect the percentage of stocks actually participating in market advances, or actually incurring losses during market declines.

Advance-Decline Measures

Advancing issues are stocks that rise in price; declining issues are stocks that fall in price. The most favorable market climates take place during periods when the price actions of the major market indices are generally favorable and when market breadth readings are favorable — more stocks advancing than declining.

The advance-decline line is a cumulative total of daily advances minus declines that may be maintained on any and all popular indices. As a general rule, it is bullish when:

- New peaks in the major market indices are confirmed by concurrent new peaks in the advance-decline line.
- The percentage of issues advancing in price over a 10-day period is more than 60 percent of the total number of issues advancing or declining.
- Market breadth remains positive even when market indices decline.

As a general rule, it is bearish when:

- New peaks in the major market indices are not confirmed by new peaks in the advance-decline line for several months.
- There are patterns of continuing weakness in market breadth even as the price levels of major market indices maintain their advance.

The New High

— New Low Breadth Indicator

Stocks that make “new highs” have risen to their highest price in the past 52 weeks. Stocks that make “new

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lows” have declined to their lowest price in the past 52 weeks. The greater the positive disparity, new highs minus new lows, the better the stock market breadth and the more bullish the implications.

When the 10-day ratio of the number of new highs to the total number of new highs plus new lows is greater than 90 percent, this is a very bullish indicator. When this happens, it is usually safe to remain invested until the 10-day ratio declines to 80 percent.

Bottom-Finding Parameters

As a general rule, stocks tend to be pretty sold out when readings in this 10-day ratio decline to below 10 percent. Prepare to enter the stock market when you see readings at such low levels. It is best to try to confirm this indicator with other indicators, such as those related to cycles and price-earnings ratios previously discussed.

The stock market prefers unanimity in market breadth readings. What the stock market does not like to see are climates in which large numbers of stocks are rising and large numbers of stock are declining, indicating “split” stock markets. Cautionary signals occur when, on a weekly basis, the lesser of weekly new highs or new lows is greater than 7 percent of the total number of issues traded on the NYSE. Split market warning signals should probably not be taken as sell signals, but they are good indications of potential danger.

If the number of weekly new highs is 28 percent of the total number of issues traded, this is a major buy signal that remains in effect for the next 52 weeks! ●

Investing In Reits

Real Estate Investment Trusts (REITs) are entities that invest in different kinds of real estate including shopping centers, office buildings, hotels and mortgages secured by real estate.

- Equity REITs produce profit from rental income.
- Mortgage REITs lend to owners of real estate or to real estate developers.
- Hybrid REITs are a combination of Equity and Mortgage REITs.

REITs are exempt from federal taxation of their profits as long as they pay out 90 percent of their taxable income to investors, so investors in REITs have secured large dividend payouts compared to the typical stock, often in the area of 8–9 percent per year.

Large dividend payouts are a major attraction of REITs, which tend to be fairly stable in price compared to other stocks. Large dividends tend to stabilize the

price of shares, providing a source of profit apart from advances in the price of shares alone.

REITs should probably represent a reasonably significant portion of almost any diversified portfolio, not just because of their high yields. They also offer a high degree of diversification: REITs are relatively non-correlated with the price movements of other stock market sectors. Long-term investors may retain REITs in diversified long-term portfolios on pretty much of a buy-and-hold basis, trusting that the principles of diversification will produce the steady growth that is hoped for from such portfolios.

The relationship between the direction of REIT prices and the direction of interest rates suggests that the best times to buy REITs are when interest rates are peaking and just beginning to decline from high levels. REIT prices tend to advance during periods when interest rates decline, and decline during periods when interest rates rise.

REITs are purchased by investors largely for their yield. REIT yields are worth less in a climate of high and rising yields available to investors. Higher interest rates also translate into higher expenses for many REIT operators, who then pay lower mortgage costs, building costs and borrowing costs for development. Rising interest rates add to the expense of REITs.

As interest rates advance, look for signs that the Fed is preparing to lower rates. Periods during which the Fed shifts from tighter money policies to the easing of credit are likely to be excellent periods in which to accumulate high dividend paying REITs.

Selecting the Best REIT

For REIT mutual funds, look for:

- Lowest expense ratios
- Best long-term performance
- Lowest entry/exit loads
- Most consistent management. ●

Opportunities Abroad

Opportunities (as well as risks) are probably greater in emerging-country bourses than in the markets of more developed countries where companies are larger, where stocks have larger capitalization and where it may take more capital to create significant price movement in equities on their exchanges. Risks of overseas investing include: questionable government stability, currency risks, inflation risks, lack of access to information and increased volatility.

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Americans may invest in overseas stocks via: direct ownership of actual foreign shares denominated in their local currencies, American Depositary Receipts (ADRs), ownership of open-end mutual funds that invest in specific regions or countries overseas, ownership of global mutual funds whose portfolios include both U.S. and foreign shares, ownership of closed-end mutual funds that invest in markets abroad, and the ownership of ETFs that represent foreign markets.

Investing in International Bonds

Most investors will find it easier and less expensive to invest in overseas bonds by way of mutual funds, rather than by direct purchase. International bond funds tend to divide into two camps: bond funds emphasizing price and credit stability, and those seeking maximum yield and potential capital appreciation.

The best times to buy high-grade overseas income funds are when long-term interest rates appear to be peaking and getting ready to turn down and/or when the U.S. dollar appears to have peaked and is initiating a downtrend.

Lower-grade overseas income funds represent a reasonable alternative to investment in emerging market stock funds when you anticipate strength in the countries involved.

Many international closed-end bond funds provide higher potentials for return than safer income vehicles but at considerably higher risk.

American investors can reduce some of the risks created by the weakening of the dollar by setting aside capital for the purchase of overseas bond funds denominated in foreign currencies. When high-grade debt issued within a variety of large and developed countries is used, investors can considerably reduce both credit and currency risks.

Investments abroad should represent a meaningful portion of your diversified portfolios on an ongoing basis: increased during periods of public disinterest in markets overseas, and reduced in areas that become the focus of heavy speculation. ●

Trading Strategies to Get the Most From Closed-End Mutual Funds

Closed-end funds are similar to open-end mutual funds, but tend to be more aggressively managed. They differ in that:

- The number of shares that are issued by closed-end

funds is fixed

- Trading takes place between buyer and seller at negotiated prices, not necessarily at net asset value
- Trading takes place throughout the market-trading day at various exchanges.

Closed-end funds involve brokerage commissions and bid-ask spreads but are not subject to redemption fees and trading restrictions. There is ample liquidity in most funds.

Closed-end bond funds frequently involve extra risk because many use leverage to increase yield. Closed-end income funds tend to be more volatile than open-end mutual income funds, less stable in price, and not suitable for all investors. The same is true for closed-end equity funds. Closed-end mutual funds present special opportunities but also special risks.

The typical closed-end mutual fund often trades at something of a discount. A good strategy is to track current discount and premium levels in relationship to more usual levels. Discounts tend to normalize over time. If you keep track of such discounts, you will often find opportunities following market declines to purchase stock assets at truly discounted prices. Such discounts often narrow rapidly as the market recovers.

Closed-end mutual funds that are already selling at deeper-than-normal discounts from their actual share net asset values will tend to hold their prices better than funds selling at average or below-average discounts or especially premiums. ●

Final Thoughts

Evaluate your own life situation, acceptable risk levels and investment goals so you can establish appropriate portfolios. Generally, it is more important to avoid investment losses than to maximize returns.

Emphasize mutual funds and other vehicles with no-greater-than-average volatility. Assess your portfolio balance in view of your risk tolerance.

Diversify geographically, between stocks and bonds, among various industry groups and within each industry group and sector in which you invest.

Monitor your portfolios actively to maintain their balance, and rebalance at regular intervals. Carry forth your investment program in a disciplined manner.

Remain objective, independent, relatively conservative, alert and flexible — you can use opportunities to profit in any market! ●

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Summary



Increasing Profits Without Increasing Your Risk

Options Trading for The Conservative Investor

THE SUMMARY IN BRIEF

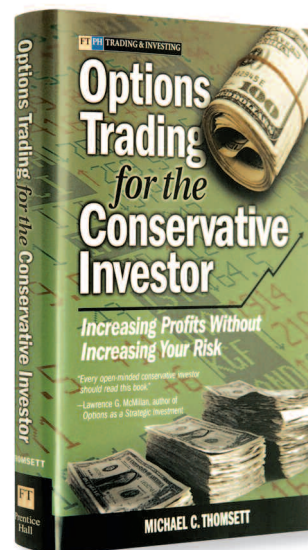
If you're an investor concerned with preserving capital, maximizing predictability and maintaining consistently strong returns, your best solution just might surprise you: Options. In *Options Trading for the Conservative Investor*, Michael C. Thomsett reveals a narrow band of options strategies that can help you improve results as you systematically reduce unnecessary risk throughout your portfolio.

To some conservative investors, options are too exotic and too risky. But we proceed on the premise that a conservative investor is not necessarily someone who does not want to expand beyond a well-understood and short list of investment possibilities. Being a conservative investor does not necessarily mean that you are unwilling to examine new ideas, expand your portfolio, or take acceptable risks. It means that you are not interested in speculation or in exposing yourself to the possibilities of high risk.

Investors tend to be aware of the potential for high returns without also acknowledging that such strategies are usually accompanied by unavoidable high risks. Conservative investors naturally seek methods for using their capital that achieve some specific goals, including: preserving spending power after both inflation and taxes; avoiding unacceptable market, liquidity and diversification risks; and protecting profits without selling securities and giving up the potential for future gain.

IN THIS SUMMARY, YOU WILL LEARN:

- The fundamental ground rules for conservative investors.
- How options can protect and enhance your conservative portfolio.
- Deciding what stocks to buy or sell options on and what to avoid.
- How to determine which options strategies are appropriate for you.
- How to recover your investments when market values have fallen.
- How to take profits without selling stock.



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THE COMPLETE SUMMARY: OPTIONS TRADING FOR THE CONSERVATIVE INVESTOR

By Michael C. Thomsett

The authors: Michael C. Thomsett has written over 60 books on investment and financial topics, including *Stock Profits: Getting to the Core*, as well as the best-selling *Getting Started in Options*, and *The LEAPS Strategist*. His best-selling *Getting Started in Options* is in its 6th edition and has sold over 200,000 copies and his *Investment and Securities Dictionary* was named Outstanding Academic Book by *Choice Magazine*. Thomsett lives in Port Townsend, Wash.

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The Ground Rules

Options are probably the most flexible investment products available. They can be used alone, in combination with other options, or as hedge devices to protect other positions.

Options are contracts that grant specific rights to the buyer and impose specific obligations on the seller. Think of options as intangible contractual rights rather than as tangible items such as shares of stock.

A put option provides the buyer with the right, but not the obligation, to sell 100 shares of a specified stock, at a specified strike price and by an expiration date, and obligates a seller to purchase 100 shares at a fixed strike price, if and when the contract is exercised by the buyer.

A call option provides the buyer with the right to purchase 100 shares of a specified stock, at a specified strike price and by an expiration date, and obligates a seller to deliver 100 shares at a fixed strike price, if and when the contract is exercised by the buyer.

The arguments in favor of options are based on a series of underlying assumptions. These ground rules should always be kept in mind:

1. Limit options activities to stocks you have prequalified as strong, long-term hold stocks, to be a permanent part of your portfolio.
2. Believe that your stocks will rise in value and you will change a hold to a sell when the fundamentals change.
3. Accept the premise that fundamental analysis of stocks is an essential first step in the process of examining options opportunities. Many first-time options traders

make the mistake of selecting options (and stocks) based on the immediate return potential, but ignore the very real market risks of the underlying stocks.

4. In a temporary downward movement in a stock's price, be happy to buy more shares.

5. Believe that there are an adequate number of available stocks that meet your criteria. ●

PART I: OPTION BASICS

The Workings of Option Contracts

The biggest hurdle in the options market is terminology and understanding the meaning of key concepts.

The attributes of the option contract determine its value. This value relates not only to how high or low the premium is, but also to how the option has value as a strategic tool in your stock portfolio.

Option contracts refer to 100 shares, so each contract allows the buyer to control 100 shares of the underlying stock (the company on which the option is bought). Every option relates specifically to that one stock and cannot be transferred.

The *premium* is the cost to the buyer or value to the seller of the option contract. This cost/value is expressed as the value per 100 shares, usually without dollar signs. For example, if an option's current premium is 6, it is worth \$600.



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Rebecca Clement: Publisher, **Tom Moore:** Senior Contributing Editor, **Joanne Merenda:** Art and Design, **Sarah Dayton:** Senior Editor

Summary: OPTIONS TRADING FOR THE CONSERVATIVE INVESTOR

The *expiration date* is a fixed date specifying when the option expires. After the expiration date, the option will no longer exist. As a buyer, you know that the time value premium will evaporate if your option is not exercised or sold before expiration dates.

The option position can be closed in one of three ways. It may expire worthless, in which case all the premium received by the seller is profit. It may be closed by buying it back at any time, with the difference between the initial sales price and final purchase price representing profit or loss. It may be exercised by the buyer, and the seller is then obligated to complete the transaction.

If you buy a call, you want your stocks to rise in value. If you buy a put, you're betting prices will fall.

In addition, the decision to go long refers to buying options; going short refers to selling them.

Intrinsic and Time Value Premium

Option premium is based on two components: intrinsic value and time value. The *intrinsic value* is equal to the number of points that an option is *in the money*. The strike price is the price at which an option can be exercised and it remains unchanged until the option expires.

If a call option has a strike price of 45, it means that it provides the buyer the right (but not the requirement) to buy 100 shares at \$45 per share. The money rules for this example are as follows:

1. If a 45 call is held on stock currently valued at \$47 per share, the option is 2 points *in the money*.
2. If the stock is valued at \$45 per share, there is no intrinsic value, also known as *at the money*.
3. If the stock is valued below the strike price, there is no intrinsic value. If the stock is selling at \$44 per share, the condition is *out of the money*.

The opposite direction applies to puts. In-the-money intrinsic value refers to the number of points the stock is below the strike price of the option. For example, if the strike price of a put is 40 and the stock is currently selling at \$37 per share, the put option contains 3 points of intrinsic value. If the stock is lower than the call's strike price or higher than the put's strike price, there is no intrinsic value.

Time value is the portion of the option premium above and beyond intrinsic value. The longer the time to expiration, the higher the time value. So time value is the key to identifying option strategy opportunities.

Long-Term Options and Their Advantages

The LEAPS (Long-term Equity Anticipation Security) option is a long-term contract that may exist for up to

36 months as compared to the 9-month maximum for a standard listed option. That longer expiration makes a lot of difference to both long and short strategies.

The expiration, and more specifically the time between opening an option position and the expiration date, determines the premium value and affects the decisions made by speculators on the long side and investors on the short side. ●

Long And Short

The decision to go long (buy options) or short (sell options) involves analyzing opposite sides of the risk spectrum. The interesting feature of options is that strategies cover the entire range of risk, often with only a subtle change.

There are circumstances in which conservative investors will want to go long in options. For example, following a large price decline in the market in a short time span, prices of strong stocks may rebound; but not being sure where the market bottom is, investors tend to be the most fearful when the greatest opportunities are present. In these cases, buying calls allows you to control shares of stock, limit potential losses and expose yourself to impressive gains — as long as prices rebound in a timely manner.

The same argument applies when stock prices rise quickly. The dilemma is that you do not want to sell shares and take profits because you want to hold the stock as a long-term investment. At the same time, you expect a price correction. In this situation, you can use long puts to offset price decline. First, if and when the price decline occurs, you can sell puts for profit. The short-term profit from puts offsets the price decline in stock. The second choice is to exercise the puts and dispose of the stock at the strike price, which would be higher than current market value.

Buying calls, the right to buy shares at a set price, is the best known and most popular option strategy, but it is usually a purely speculative move. There are exceptions. For example, if you are convinced that a stock's market value is sure to rise before the expiration of an option, you can buy calls as an alternative to outright purchase of shares when:

1. You are concerned with short-term price volatility and you do not want to commit funds to buy shares, but you still want to fix the price at the strike price value.
2. You want to buy shares, but you do not have funds available at the moment so buying a relatively cheap call is a sensible alternative given the chance that you could lose the money.

Summary: OPTIONS TRADING FOR THE CONSERVATIVE INVESTOR

3. You are aware of the risk of loss and you want to proceed with buying a call anyhow. ●

The Nature of Risk and Reward

Market risk, the tendency for stock prices to rise and fall and the volatility those price levels demonstrate, is manageable in a number of ways involving options. The most obvious is writing covered calls to reduce your basis in stock to create downside protection and take paper profits. Timing covered calls for price peaks is the most advantageous. If you expect overbuying short-term trends to correct in the near future, writing a call can produce fast option profits. This form of profit taking does not require you to sell shares.

Another way to manage market risk is to time option strategies for a stock's pricing trends. When prices rise much more quickly than you expect, you may buy puts in anticipation of a reversal in that trend. Buying puts is normally considered speculative, but when you buy relatively cheap puts to protect stock profits, it is a form of insurance.

As another alternative, you do not have to take any action. You could listen to your conservative voice and decide to simply wait out the short-term trends, reminding yourself that the fundamentals of the company continue to indicate a hold policy.

Lost Opportunity Risk and Options

The risk that the stock's price will decline exists whether you write calls or not. But there is also the lost *opportunity risk* to consider. If the stock's price soars far above the strike price of the covered call, you may lose shares through exercise. Your stock may have to be sold at the fixed strike price when that strike price is below the current market value.

Is writing covered calls worth the lost opportunity risk? When you remember that your stocks tend to be conservative in the first place, how many of your issues are likely to soar in price? When you compare the certainty of short-term returns from writing covered calls to the risk of losing appreciated price in the stock, you realize that the consistency in writing covered calls produces higher overall profits. ●

Short Positions, Naked or Covered

Some strategies involving short calls and puts may conform to your conservative risk profile based on prevailing market conditions and your portfolio positions. The basic

covered calls strategy is the most obvious example.

However, uncovered calls have to be viewed as one of the highest risk strategies possible, and not a good fit in your conservative portfolio without modification. ●

PART II: MANAGING PROFITS AND LOSSES

The Conservative Investor's Dilemma

The conservative risk profile discourages short-term decisions, but does not preclude protecting profits when price levels become volatile.

Options can be employed to protect profits and even take those profits without selling stock and without taking market risks. Options can also be used to eliminate loss positions through rescue strategies.

The ongoing conflict between short-term market trends and your long-term mindset is efficiently managed with options as long as they are used for managing price volatility and not as a primary and speculative change in policy.

But in the long-term context, short-term price changes and the reasons for price volatility really have nothing to do with long-term value. Conservative investing emphasizes fundamental corporate strength — competitive position, excellence of management, diversification, healthy capitalization, consistent dividend record — all based on faith in long-term fundamental indicators. ●

Managing Profits With Options

The very real problem of “managing” profits is often ignored by investors. It may seem odd to refer to the “management” of profits because the usual thinking is, you either sell to take profits or leave them intact. But in fact, management is precisely what you want to do, even when your primary emphasis is on long-term growth.

The traditional advice to buy long-term stocks and ignore short-term volatility is generally good advice. But ironically, it may also be irresponsible to simply leave it at that. Your on-going portfolio management involves monitoring fundamental indicators. If and when corporate strength, competitive position, dividend payments, earnings trends, capitalization and other fundamentals change, you may decide to sell shares and redirect a portion of your capital elsewhere.

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The two methods of protecting profits with options are buying puts and selling covered calls. ●

Overcoming The Profit-Taking Problem

While you may not want to take profits just because the current price of stock is higher than your basis, it would certainly be desirable to take those profits without selling stock, using the following guidelines:

1. Use long puts as insurance to ensure that current profitable prices are protected.
2. Use long calls only as a form of contingent purchase, when long-term options are available and when the purpose is to reserve the possibility of exercising those calls to purchase shares of stock.
3. Use long calls if and when prices of stocks you currently own have fallen rapidly due to marketwide price declines.
4. Use short puts as a form of contingent purchase (you have shares put to you at the strike price if and when exercised) only when you would be pleased to purchase shares at the net price.
5. Use short puts in place of long calls when prices of stock you own have declined and you expect near-term prices to rise.

When is the decision to employ options speculative and when is it a valid conservative strategy? One consideration is whether or not you already have a position in the stock. As long as your purpose in using options is to protect profits, exploit price spikes, or average down your cost of stock, your conservative standards are compatible with using options. ●

Managing The Inertia Problem

For some conservative investors, the problem may not be in mastering the complexities of option trading. It may be inertia — becoming overcautious and failing to act when the timing is right. Inertia is another word for lost opportunity. Some suggestions for dealing with it include:

1. **Set goals in advance.** The emotional block to taking decisive action is a common flaw you can overcome by operating from the base of your own rules.
2. **Follow your own rules without exception.** Once your rules are set and analyzed critically, follow them without fail, even if your instinct tells you to wait and see or to take a different action.
3. **Develop two-part strategies.** What if prices

rise? What if they fall? Plan your actions based on worst-case scenarios.

4. **Consider closing positions when risk attributes change.** Volatility is often more than cyclical market change; it may also be a symptom of a change in the stock's fundamental profile, indicating a need for further investigation. ●

PART III: OPTIONS AS CASH GENERATORS

The Covered Call Concept

The covered call is among the most attractive of conservative option strategies. It provides an impressive rate of return when properly structured and it does not increase the most common forms of risk. The key is in exploiting the time value premium. For the strategy to make sense, your basis in stock must justify the short position (selling options), the option premium must be adequate to justify the risk of exercise, and you must know the tax ramifications before you open short positions.

A covered call strategy has two elements. First is the ownership of 100 shares of stock for each option to be covered. Second is the short position in the call option. If you own 100 shares, you sell one call to achieve the one-to-one “covered” status. The call grants the right to the buyer on the other side of the transaction to buy your 100 shares (to call them away) at the set strike price at any time from the date of sale until expiration. As long as the current price of stock is below the strike price, the call is not likely to be exercised.

When you enter a covered call position, you are selling the call against stock you own. This means you give the right to exercise to the buyer and that decision is entirely in the buyer's hands. You are allowed to keep the cash you receive upon selling the short call, whether the call is exercised or simply expires. You also continue to receive dividends during the period you are short on the call.

The advantage to selling covered calls is that it produces instant cash. You are paid for selling the call. The disadvantage is that you tie up 100 shares for each call sold, and you cannot escape from the covered position without closing out the short call. ●

Working Within Pre-Established Standards

The covered call strategy is conservative, assuming that you understand the transaction's specific attributes

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and you are sure the numbers work in your favor. Observe the following rules to ensure a truly conservative application:

1. Your original purchase price has to justify the strategy.
2. The premium value you will receive has to provide enough yield to justify the covered call exposure.
3. You are willing to accept exercise as one of the possible outcomes.
4. You are aware of the tax consequences in the event of exercise.
5. You are aware of the possible loss of future market gains if and when stock prices exceed the call's strike price.
6. The covered call strategy commits the capital invested in stock for as long as the short call remains open.
7. Your primary portfolio strategy has to remain the same, seeking long-term investment in the stock of properly selected companies, not in selecting stocks based only on potential covered call returns. ●

Rolling Forward And Up

While covered call writers have to accept the possibility of exercise, it is often preferable to keep well-selected stocks in the portfolio and to take steps to a) avoid having it called away, b) be able to continue writing subsequent calls, and c) in the event of exercise, maximize income from the transaction. All of this requires employing the *rolling* technique.

In a roll, you close out a current open position and at the same time open a subsequent position that has one of the following attributes:

1. **A roll forward.** The new covered call expires later than the old covered call but at the same strike price.
2. **A roll up.** The new covered call expires at the same time but at a higher strike price.
3. **A roll forward and up.** The new covered call expires later than the old covered call and at a higher strike price. ●

The Exercise Acceptance

A final strategy worth mentioning is the exercise acceptance strategy. Most conservative investors are content to keep their long-term stocks and to use well-selected out-of-the-money calls to create additional profits along with downside protection. However, what if you would be happy to see your call exercised?

For example, if you bought shares of Federal Express at \$72 per share two years ago and that stock has a current market value of \$87.78 per share, you would be happy to

sell today and take a 15.78-point long-term capital gain. However, you could sell a covered call expiring in 27 months and gain even more. Today, the 27-month 90 calls sell for \$1,230. If exercised, you could keep the \$1,230 and earn capital gains.

Selling covered calls is a profitable alternative to simply owning stock. You can also force exercise by intentionally writing in-the-money calls. However, because this ensures the loss of long-term status of capital gains when exercise occurs, the strategy has to be studied on an after-tax basis. ●

PART IV: ALTERNATIVES TO STOCK PURCHASE

Leverage And Options

With options, there are many safe ways to enter the market. Contingent purchase using either long calls or short puts is a powerful weapon in your strategic arsenal.

Contingent sale — represented by the covered call strategy — is the most conservative use of options. However, you can also use options to leverage capital in several forms of contingent purchase. As an alternative to buying shares of stock, you can either buy calls or sell puts with the intention of acquiring stock before expiration. This strategy is appropriate when the market is volatile or when market-wide prices fall significantly. You recognize the buying opportunity, yet you do not want to risk capital on stock that might continue to fall even more.

The ability to leave positions open for as long as three years makes LEAPS well suited for this range of strategies, whereas traditional listed options do not survive long enough for contingency to mature. The risks are simply too great that the option's life will end before stock prices move adequately. This is especially true when you employ contingent strategies with long calls.

Applications of Contingent Purchase

Contingent purchase is a way to fix the price of stock if and when you buy shares (in the case of calls) or if stock is put to you. In either case, the basic rules remain:

1. You would be pleased to acquire stock at the indicated strike price.
2. You can afford to buy the stock.
3. You have performed fundamental analysis and found the company suitable.
4. The contingent-purchase strategy is appropriate and you are comfortable with it as an alternative to simply buying shares at the current price.

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Just as any options strategy is wrong when based solely on option premium levels, using contingent purchase without intending to buy stock is wrong as well.

Contingent purchase is appropriate only if you intend to buy shares, and your purpose in employing the strategy should be to limit current risk and not to incur more. ●

The Long-Call Contingent Purchase Strategy

The first contingent strategy involves buying calls instead of stock. This would be a speculative move if the only purpose was to create profits in call premium. However, as long as your intention is to buy shares, this strategy fixes your future purchase price at the strike price. If you buy calls in several stocks and only some increase in value, you should exercise those calls only on profitable positions.

The strategy should involve several different stocks. This diversifies your exposure in a long-option position. ●

The Covered Long Call

The major risk involved with long-call contingent purchase is if expiration occurs before an adequate price increase occurs in the underlying stock, it is extremely difficult to make a profit. Even if the stock's market value rises, you still need to overcome the time value problem.

There is a way to achieve this. Assuming that some or all of the stocks increase in value before expiration, you can employ a secondary strategy designed to recapture the premium cost of the long call. The basic strategy is to sell a call with a higher strike price and earlier expiration than the long positions. ●

Short Puts And Contingent Purchase

You are not limited to long LEAPS calls to enter a contingent purchase strategy. You can also use short puts. When you sell puts, you are required by your brokerage firm to have adequate funds on deposit to satisfy exercise of the put, if and when that occurs.

The benefit of the put strategy is that money flows to you rather than away from you. Time value is also an advantage. You receive a premium for selling the put, and that premium value declines over time, even when the stock's value falls to in-the-money price levels. Time value may offset intrinsic value to a degree.

The value of shorter exposure terms is:

1. Less time is required for leaving funds on deposit.
 2. Turnover profits are higher.
 3. Time value premium declines more rapidly. ●
-

Additional Conservative Strategies

Investors often describe themselves as conservative, but they act irrationally when sudden and unexpected trends emerge. Fear and greed often have more to do with decision making than does prudent or analytical, strategic thinking. How can you avoid making the common mistakes?

Some options moves qualify as conservative strategies — as long as the purpose is to manage the portfolio rather than to simply speculate. You can use long puts or calls to manage price change, and short puts — with their limited risk — present great opportunities as long as they are used solely when you would be happy to acquire more shares of the underlying stock. ●

The Long Put: The Overlooked Option

The temptation is to sell shares at the market top and take profits. This is a dilemma. You want to keep shares for the long term, but you also want to protect paper profits. If you don't want to sell shares, buying long puts is a sensible alternative.

The strategy of buying puts to ensure paper profits (or even to provide a safe floor for your purchase price of shares) is a system for managing short-term volatility while continuing to execute the long-term conservative policies you have established in your portfolio. This is not mere speculation; it is a method for protecting current value at a relatively small cost.

When a stock's price falls, long puts are used. In this situation, you may recognize a buying opportunity on an intellectual level, but you also fear further declines. So you use long puts to provide an immediate floor for stocks in your portfolio. In cases of extreme short-term volatility, you can combine long puts with long calls. Long puts protect your capital value in case of a further decline. At the same time, a price rebound would make the long calls profitable. ●

Short Puts: A Variety of Strategies

In a down market, you face the dilemma of wanting to take advantage of buying opportunities, but you're not sure

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where the market is going. The conservative point of view recognizes down markets as the chance to pick up more shares of your favorite stocks. When you buy cheap shares, you lower your overall basis in a stock, and that improves long-term as well as current income potential.

Given the fear factor in down markets, you may hesitate to put a lot of capital into shares. What if the market continues to fall? What if it takes months instead of days to recover? This is where short puts are especially valuable. There is always the possibility that stock prices will fall and not recover. The value of using options is that strategies may exploit temporary price declines. When prices fall and remain down, options reduce the losses (if you use short options) or provide the opportunity for recovery with limited additional cost (if you use long options). ●

PART V: OPTION STRATEGIES IN DOWN MARKETS

Using Calls In Down Markets

Using puts to average down your basis and acquire more shares — or to increase income when those short puts are not exercised — is one way to manage your portfolio in a down market.

An essential element of using calls in down markets is the reduction of losses caused by further downside movement. Premium earned for writing short calls reduces net basis in stock, which also helps close the gap between basis and current market value.

Long puts or long calls provide profitable outcomes as long as stock prices move enough in the desired direction. The problem with long-option positions is twofold. First, time works against you when you buy options. Second, time value declines as expiration approaches, requiring far more price movement in the stock to justify the decision to go long in the option. ●

PART VI: COMBINATION CONSERVATIVE TECHNIQUES

Spread And Straddle Techniques

The most impressive returns available using options involve combination strategies: spreads and straddles. However, in utilizing these more advanced strategies, there are two important points to remember. First, the complex tax rules for such positions could jeopardize your long-term capital gains status. Second, the risks involved are

conservative only if and when the basic assumptions continue to apply. These include your willingness to acquire more shares of stock and to accept exercise if and when it occurs, and your continued belief that the fundamental value of the companies remains strong.

A *spread*, the opening of two or more option positions on the same stock, involves different expiration dates or different strike prices. A more complex spread involves both different expiration and strike features.

A *vertical spread* has different strike prices but the same expiration date. A *horizontal spread* is the opposite: It contains the same strike price but different expiration dates. A *diagonal spread* has different strike prices and different expirations.

The spread is distinguished in other ways as well. For example, a *bull spread* is one designed to work out profitably if and when the value of the underlying stock rises. In comparison, a *bear spread* is maximized when the underlying stock's value declines. A *box spread* is the simultaneous opening of a bull spread and a bear spread.

The terminology is even more complex than these basic definitions. For example, a *ratio calendar spread* is any spread in which the long and short positions are not identical numbers. One final advanced spread is called the *butterfly spread*. This strategy has three parts: open options within a strike-price range, offset by other options at both higher and lower strike price ranges.

While the spread involves variation of strike price, expiration date or both, the *straddle*, by definition, requires that strike price and expiration are the same. To open a straddle, you buy an equal number of calls and puts (a long straddle) or sell an equal number of calls and puts (a short straddle); in either case, the option positions would have the same strike price and expiration date. The long straddle is highly speculative.

Simplicity as a Worthy Goal

The complexity of combination strategies is only one of the problems you have to sort through. As a conservative investor, you may prefer simplicity, if only because basic conservative strategies involve fewer likely risks. The possible tax consequences may also discourage you from complex strategies.

One conservative principle worth adopting is: Keep it simple. The fall-back position for any option strategy is to return to the basic conservative theme: Select high-quality growth stocks and hold for the long term selling only if and when the fundamentals change. If any options strategy is overly complex or difficult to understand, it should be avoided without exception. ●

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Summary



The Key to Making Your Money Last as Long as You Do

Retire Secure! Pay Taxes Later

THE SUMMARY IN BRIEF

In *Retire Secure! Pay Taxes Later*, Attorney and CPA James Lange provides proven strategies for getting the most from your IRA or retirement plan. Lange presents compelling evidence that all retirement plans are not equal. The federal tax treatment for IRAs, Roth IRAs, 401(k)s and other retirement plans is different — and the differences can have long-term consequences. Tax-savvy decision-making could mean hundreds of thousands of additional dollars growing in your coffers. Uninformed decision-making can jeopardize your long-term security. To take full advantage of the preferential tax treatment, employees need to learn which plans to invest in and which order to fund them. Then, once they move into retirement, retirees need to know the best order in which to spend those assets.

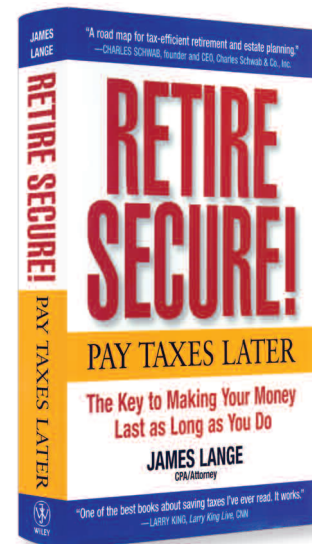
Lange provides multi-faceted tax strategies for maximizing your retirement savings while you are working and creative techniques to sustain those savings throughout your retirement. Ultimately, he demonstrates how to integrate retirement planning with estate planning to protect and provide for your heirs. Two key issues he discusses are proper titling for inherited IRAs and how to specify beneficiaries for IRAs and 401(k)s to minimize federal taxes. He also addresses the most tax-effective ways to donate to charity.

Lange's skilled analysis, experience, insight and realistic case studies demonstrate how to improve the odds that you and your spouse will have sufficient income for the rest of your lives and even improve the prospects for your children and grandchildren.

Retire Secure! Pay Taxes Later shows that taking action today to reduce your tax burden greatly enhances your chances of financial security tomorrow.

IN THIS SUMMARY, YOU WILL LEARN:

- Improve your financial outlook with the tax-free growth of a Roth IRA, Roth 401(k), and/or a Roth IRA conversion.
- Cut taxes on IRA withdrawals.
- Dramatically reduce your risk of running out of money.



by James Lange

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THE COMPLETE SUMMARY: RETIRE SECURE! PAY TAXES LATER

by James Lange

The author: James Lange, CPA/attorney, is a nationally respected IRA, 401(k) and retirement-plan distribution expert with 27 years of hands-on experience. In *Newsweek*, Jane Bryant Quinn introduced the country to Jim's mantra, "Pay Taxes Later!" His advice has been cited many times in the *Wall Street Journal*, and his articles appear frequently in other prestigious financial and tax journals.

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PART I: THE ACCUMULATION YEARS: THE BEST WAY TO SAVE FOR RETIREMENT

Fund Retirement Plans to the Maximum

Contribute the maximum you can afford to your retirement plan. Money contributed to a retirement plan, whether a 401(k), 403(b), SEP (Simplified Employee Pension), SIMPLE (Savings Incentive Match Plans for Employees), 457, deductible IRA or any other type of retirement plan, is a pre-tax investment that grows tax-deferred. There are no federal income taxes on the wages contributed. You are getting a tax break for the amount of the contribution multiplied by the tax rate of your tax bracket.

In addition, once the contribution is made, you do not have to pay income taxes on the interest, dividends and appreciation until you take a distribution (i.e., withdrawal) from the retirement plan. In other words, you pay taxes later.

By not paying the taxes upfront on the wages earned, you reap the harvest of compounding interest on the money that would have gone to paying taxes — both on the amount contributed and on the growth had the money been invested outside of the retirement plan.

The built-in discipline of automatic contributions to your retirement plan works to your advantage. Those who have the most money saved at retirement are usually the ones who religiously contributed to a retirement plan during their long career.

The Employer Matching Retirement Plan

It would be foolish not to contribute to your employer's matching plan. Matching contributions are most commonly found in 401(k), 403(b) and 457 plans. The cardinal rule is: Contribute whatever the employer is willing to match — even if the match is only a percentage of your contribution and not dollar for dollar.

Remember that you may qualify for more than one retirement plan such as a 403(b) with a 457 plan and a Roth IRA. You might want to consult a financial advisor to learn about all your options. The key is to selectively contribute the maximum you can afford to an optimized hierarchy of retirement plans — begin with tax-deferred contributions to your employer matching plan, follow with Roth contributions to Roth IRAs or Roth 401(k)s (if available) and then other plans to the extent possible. ●

Comparing the Traditional IRA and Roth IRA

The Roth IRA is usually preferable to a traditional IRA or a non-matched contribution to an employer's retirement plan.

IRAs allow individuals with earned income to make contributions to their own retirement accounts. IRA owners can deduct IRA contributions if they (and their spouse if married) do not have a retirement plan at work, and they earn less than the adjusted gross income limit prescribed by law for deducting IRA contributions.

Within limits, the IRA owner deducts the contribution to the IRA and the IRA grows tax-deferred. The owner does not pay income taxes until the money is



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Rebecca S. Clement, Publisher; Sarah T. Dayton, Editor In Chief; Joanne Merenda, Graphic Designer; Dan Stuenzi, Contributing Editor

Summary: RETIRE SECURE! PAY TAXES LATER

FIGURE 1: THE TRADITIONAL AND ROTH IRA QUICK COMPARISON

	Roth IRA	IRA
Investment	Grows tax-free	Grows tax-deferred
Withdrawals	Tax-free	Taxed as Income
Contributions	Not deductible	Deductible
Income Limits	Much higher than for IRA	Much lower than Roth IRA
Contribution Limits	Same as IRA	Same as Roth IRA
Penalty for withdrawal before 59 1/2	No, limited to previous contributions	Yes, with limited exceptions
Required distributions at 70 1/2	No	Yes

withdrawn, at which point the distribution will be subject to federal income taxes. Many employer-provided retirement plans can be rolled over into an IRA, income tax-free, at retirement or termination of employment.

However, the most recent tax legislation, the Pension Protection Act, reduces the urgency to roll a 401(k) into an IRA because the new law basically offers inherited 401(k)s the same tax treatment as inherited IRAs. In some cases it may be better to hang onto the 401(k) because some of the money may be invested in a bond fund, or fixed income fund paying returns in excess of today's fixed income or bond funds.

What Makes a Roth IRA So Great?

With a Roth IRA you contribute after-tax money so you don't get an income-tax deduction for your contribution. As with the traditional IRA, you don't pay income tax while the Roth IRA is invested. The striking advantage, however, is that when you (or even your heirs) eventually do make a withdrawal from your Roth IRA, that distribution is income tax-free! By contrast, the distribution from a traditional IRA will be taxable. (Figure 1 simplifies the comparison of Roth IRAs versus traditional IRAs.) ●

PART II: THE DISTRIBUTION YEARS: SPEND THE RIGHT FUNDS FIRST

Which Assets Should I Spend First?

With retirement, an individual moves into distribution mode — that is, beginning to spend one's retirement savings. That is not to say that accumulation stops. You may be fortunate enough to find that your Social Security, dividends and interest on investments, pension and required distributions from your IRA (if any) produce enough funds for your living expenses.

Let's assume that isn't the case, however, and you are forced to either invade your after-tax savings (your nest egg) or make (additional) taxable withdrawals from your IRA or retirement account to make ends meet. In general, it is preferable to spend principal from your after-tax investments rather than taking taxable distributions from your IRA and/or retirement plan. Leaving money in the tax-deferred environment for as long as possible confers advantages that almost always outweigh concerns over paying capital gains on your after-tax assets.

The Optimal Order for Spending Classes of Assets

1. After-Tax Assets Generated by Income Sources
 - Pension distributions
 - Dividends, interest, and capital gains
 - Earned income, not reinvested
 - Social Security
 - Required minimum distributions from IRAs
2. After-Tax Assets (Investments that are not part of a qualified pretax retirement plan that would generate income subject to taxes annually):
 - Investments that will either sell at a loss or break even
 - Then, more highly appreciated assets
3. IRA and Retirement Plan Assets (Assets subject to ordinary income tax):
 - IRA, 403(b), 401(k), etc., dollars over and above minimum required distributions
4. Roth IRA dollars ●

Minimum Required Distribution Rules

Even if you stick to the game plan to spend your income and after-tax dollars first, you will eventually be required to withdraw funds from your IRA (not your Roth IRA) or qualified retirement plan. For most peo-

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ple, annual minimum distributions must begin by April 1 of the year following the year that you reach 70 1/2. An exception to the rule: If you have an employer plan and have not yet retired, you can delay the first distribution until April 1 of the year following the year you retire. (This exception doesn't apply if you own more than 5 percent of the company.)

Calculating Your MRD after Age 70 1/2

The minimum required distribution (MRD) is calculated by taking your projected distribution period (based on your age and the age of a beneficiary deemed to be 10 years younger than you), and dividing that factor into the total balance of your IRA or qualified plan as of December 31 of the prior year. Your projected life expectancy is an actuarial calculation done by the IRS and found on one of three life-expectancy tables.

Most IRA owners will use Table III, the Uniform Lifetime Table, which is based on the joint life expectancy projections of an IRA owner and a hypothetical beneficiary 10 years younger. Using a joint life expectancy is advantageous because it reduces the annual minimum required distribution. Table II is geared toward married individuals when the IRA owner is 10 or more years older than the spouse beneficiary, and Table I is geared toward non-spouse beneficiaries of inherited IRAs.

If you can afford it, take only the minimum the government requires you to withdraw from your retirement plan or IRA. This distribution pattern retains more money in the tax-deferred account and is consistent with the motto, don't pay taxes now — pay taxes later. It's important to note that taking only the minimum required distribution does not prevent you from withdrawing more money should the need arise. ●

Critical Decisions You Face At Retirement

When someone retires or is "service terminated," the big question is, "What should I do now?" Contingent on retirement-plan specifics, the basic options are:

1. *Transfer the money into a separate IRA.* (Often the preferred option.)
2. *Leave the money in the plan where it already is.*
3. *Annuitize the balance.*
4. *Combine options 1, 2 and 3 in some way.*
5. *Take a lump-sum distribution.* (However, many retirees

won't qualify for a lump-sum distribution, and most financial advisors won't recommend it.

New Considerations Regarding Transferring a 401(k) or Other Plan Into an IRA★

★ This information reflects new recommendations taking into account the Pension Protection Act passed after the publication of the book.

With proper planning you can put in place the mechanisms to stretch taxable distributions from an inherited IRA and certain retirement plans for decades, sometimes as long as 80 years after the original owner dies. Prior to the passing of the Pension Protection Act (PPA) that option was not always available for non-spouse heirs of 401(k)s or 403(b)s. Failing to roll a 401(k) into an IRA often had terrible tax consequences for the non-spouse beneficiary.

Now, it is possible to arrange a trustee-to-trustee transfer of an inherited 401(k) to an inherited IRA. The new law basically offers inherited 401(k)s the same tax treatment as inherited IRAs. The 401(k) owner should now make the decision to rollover or not to rollover based on investment reasons, not tax reasons.

Many of the old 401(k) plans have a great fixed income fund as one of their components paying returns in excess of today's fixed income or bond funds. The old law forced a choice between offering the non-spouse heir the tax benefits of the stretch IRA and the owner's interest in keeping the money in the better-than-average fixed income fund in the 401(k).

One recommendation is to retain the fixed income portion of the portfolio in the 401(k). The stock and growth portion of the 401(k) could be rolled into an IRA to take advantage of the broader spectrum of investment options offered through IRAs.

Investment Reasons to Transfer to an IRA

Perhaps even more compelling than the tax reasons to transfer the money out of the retirement plan and into an IRA is the opportunity to take advantage of the universe of investment choices offered by IRAs. That argument becomes even more critical if your plan does not offer good investment choices. Though the trend is to give employees more choices and more advice than in the past, transferring the money into an IRA will always give the retiree more and often better choices.

For most individuals approaching or at retirement, initiating a trustee-to-trustee transfer of a qualified retirement plan to an IRA is a good decision. With proper titling, you can preserve the stretch, and you can offer

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your heirs the continued advantage of tax-deferred growth and take advantage of a wider variety of investment choices during your lifetime. That said, you still have to weigh the decision carefully and look at the particular circumstances of your situation.

Deciding how to manage your retirement assets at the time you retire is important and deserves your full attention. Deciding on a good strategy is an area where the appropriate financial advisor can be worth his or her weight in gold.

Does Annuitizing Your Distributions Make Sense for You?

Annuitizing your retirement plan or “after-tax” accumulations can be one way to make sure you don’t outlive your money. For some individuals, annuitizing part of their financial assets is a reasonable choice.

Annuitizing your retirement plan accumulations or after-tax money means purchasing an immediate annuity. That involves surrendering all or a portion of your money in exchange for receiving regular, recurring payments. The basic concepts of annuitizing apply to both retirement funds and after-tax funds. The major difference is the income-tax treatment of the annuity payments.

Payments from an after-tax annuity are partially taxable in the early part of the payment stream. They are partially taxable because one portion of the payment is considered a return of the original capital and is not taxable until the entire original cost is recovered. The other portion of the payment is considered ordinary taxable income. Distributions from annuities purchased with retirement funds, on the other hand, are fully taxable like pension income.

Terms and duration of annuity payments vary. Usually, the choices include receiving payments for:

- The remainder of your life
- The remainder of your and your spouse’s life
- A fixed number of years
- One of the above plans with an extra provision to extend benefits to your heirs.

Annuitizing: A Conservative or Risky Strategy?

An ideal candidate for an annuity is a healthy single person with a long life expectancy who doesn’t care about leaving any money behind. If the person is married, then a joint life annuity to last through both lifetimes could work equally well. Annuitizing over a lifetime or joint lifetimes is sometimes considered a

conservative strategy because it practically ensures that you will not outlive your money. And it’s possible to annuitize only a portion of the available funds.

On the other hand, some would consider annuitizing a gamble. Since most annuities are based on an actuarial life expectancy, you are gambling that you will outlive your actuarial life expectancy, and the insurance company is gambling that you won’t. If you have reason to believe that you will not survive your actuarial life expectancy, then annuitizing is probably a mistake.

If you don’t need the money, then annuitizing retirement plan assets needlessly accelerates the payment of income taxes on your retirement accumulations. Also, if you need more than the annuity payment and you’ve annuitized everything, then you’re out of luck unless you can borrow from a bank or other lending institution. If, on the other hand, you are taking minimum required distributions from a retirement plan, you can always take a larger distribution from principal when and if you need it. This is, of course, the fundamental risk of annuities. ●

Net Unrealized Appreciation

The difference between the market value of your company stock still invested in your retirement plan at the time of distribution and its value at the time your employer made the contribution to your plan is called net unrealized appreciation or NUA. At retirement, it is critical to check for NUA before rolling money into an IRA; NUA qualifies for favorable tax treatment.

Employers, in spite of the Enron fiasco, are still allowed to fund qualified plans with their own stock, using fair market value to value the contribution. A pension plan may not have more than 10 percent of its assets invested in employer stock. For certain plans, such as stock bonus plans, all contributions are in employer stock. Profit-sharing plans may have 100 percent of their assets invested in employer stock.

If the proposed distribution from a retirement plan qualifies as a lump-sum distribution, then the NUA is not taxed at the time of distribution. The employee pays tax only on the original value of the stock when the employer contributed it. Employees do not pay tax on the NUA portion until they sell or otherwise dispose of the stock. The employee then pays taxes at the capital gains rates instead of ordinary income rates as in traditional IRAs.

Getting a handle on NUA could present a tremendous savings opportunity. ●

PART III: ESTATE PLANNING: IT'S NEVER TOO EARLY TO START

There is a reason that the words “retirement and estate planning” seem to roll off the tongue — they belong together. It is important to understand that the consequences of your decisions may have immediate, short- and long-term tax ramifications. Plan with the big picture in mind, and keep things flexible. Integrated planning always beats out something cobbled together. ●

Reducing Your Federal Estate Tax Burden

The federal gift- and estate-tax system is a transfer tax levied when individuals transfer assets during their lifetime (gift tax) or at their death (estate tax). It's rare that individuals pay gift taxes during their lifetime, so most often the transfer taxes are imposed on the death transfer.

The unlimited marital deduction allows you to transfer an unlimited amount of property to your U.S. citizen spouse, during his or her lifetime or at death, free of transfer taxes. For transfers to non-spouses (such as children and grandchildren), the IRS sets an upper lifetime limit on how much money can be transferred out of an estate before a transfer tax is charged. The amount an individual is allowed to transfer to non-spouse beneficiaries without incurring a federal transfer tax is referred to as the Applicable Exclusion Amount. Unfortunately, the Applicable Exclusion Amount is a moving target because of current legislation.

For the years 2006–2008, the Applicable Exclusion Amount for federal estate tax equals \$2 million. During 2009 it will be \$3.5 million. In year 2010 the estate tax is scheduled to be repealed altogether! And in 2011, unless Congress takes action, the estate tax comes back and the Applicable Exclusion Amount reverts to \$1 million. The lower the Applicable Exclusion Amount, the higher the number of Americans subject to the transfer tax. Obviously, this state of flux requires flexibility in your planning.

For married couples whose assets exceed the Applicable Exclusion Amount, the concern is not with the estate tax on the first death (because of the unlimited marital deduction), but rather the estate tax at the second death. It is usually recommended that husband and wife

divide their assets equally, or as close to equally as possible. That way each can pass the maximum amount possible using their Applicable Exclusion Amount.

The Exemption Equivalent Amount Trust

One method of minimizing federal estate taxes has been to draft a trust that, upon the first spouse's death, protects from estate taxation that spouse's applicable exclusion amount. The trust normally carries limitations so that the surviving spouse is only permitted to use the income from the trust, and may invade principal for health, education, maintenance and support. Because of these limitations, the trust is not considered part of the estate of the surviving spouse and is therefore not subject to estate tax at the second death.

Because of the constant change in tax laws and estate sizes, you could inadvertently and unnecessarily be under-providing for your surviving spouse by transferring too much money to such a trust. If the raised exemption amounts remain in place, fewer estates will be subject to estate tax, and fewer estates will benefit from this trust. Don't get caught with an estate plan that automatically transfers the Applicable Exclusion Amount into a restricted trust for the benefit of your spouse without making sure that is the best choice.

The Importance of Annual Gifting

This most effective way to reduce estate taxes is with annual gifts. Lange often recommends a combination of his three favorite simple gifting strategies.

1. Cash (or stock) Gifts of \$12,000 Per Year Per Beneficiary

The IRS allows each individual to make an annual tax-free gift of \$12,000 per year to an unlimited number of beneficiaries. Couples may gift \$24,000/year per beneficiary. Not only is the amount of the gift out of the donor's estate, but the appreciation that would have occurred in the estate is also outside of the estate at the owner's death.

2. The Gift of Education

Section 529 College Savings Plans provide income-tax-free growth, give you the freedom to change beneficiaries within the family, offer substantial control over the asset allocation of the investment, and even allow you to take the money back and use the proceeds for non-qualifying purposes (subject to a 10 percent penalty). If you make a 529 gift and die, the balance of the 529 account is not included in your estate.

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You may also pay for your children's or grandchildren's tuition and medical expenses which do not count against the \$12,000 limitation.

3. Gifts of Life Insurance Premiums

Provide premium payments to purchase a second-to-die or other type of insurance policy that can be used to replace the amount taken by estate taxes, or provide liquidity to pay the taxes, leaving the rest of the inheritance intact. The policy would likely be owned by the beneficiaries or an irrevocable trust to keep the insurance proceeds outside the taxable estate.

Gift Taxes

There is a separate Applicable Exclusion Amount for gift taxes. There is a \$1 million cap on the total value of gifts you can give during your lifetime (beyond the \$12,000 annual exclusion) before being subject to gift tax.

If your gifts to one beneficiary exceed the \$12,000 annual exclusion amount, the excess goes against your \$1 million cap. It is often a good strategy to give more than \$12,000/year per beneficiary. Exceeding the \$1 million total cap will subject you to a graduated gift tax with rates ranging from 18 to 46 percent in 2007. ●

Using the Minimum Required Distribution Rules After Death

Just as you can profit from deferring income taxes during your lifetime, so can your heirs. Just as it was advantageous for you to keep money in your IRA, it is also best for the beneficiaries of IRAs to retain the money in the tax-deferred environment for as long as possible.

Stretch IRAs and Who Can Inherit Them

A stretch IRA is an IRA that capitalizes on a younger beneficiary's longer life expectancy. This results in lower minimum required distributions and a longer time frame for the assets to remain in the tax-deferred environment.

The inherited IRA has a greater tax-deferral potential for the surviving spouse's child than for the surviving spouse. It would have its greatest tax-deferral potential in the hands of a grandchild or even a great-grandchild.

If the beneficiary is still a minor, a well-drafted trust will often be the best choice for the beneficiary. There

are technical requirements for a trust to qualify as a designated beneficiary and get the stretch treatment. This is an area where an attorney's input is advisable — as long as that attorney is experienced in drafting trusts designed to serve as an IRA beneficiary.

It is important to discuss these stretch concepts with your beneficiaries so that they are aware of the material advantages of taking only the required minimum distributions for as long as possible. ●

Using Disclaimers In Estate Planning

An individual who disclaims an inheritance simply steps aside and the next person in line (the contingent beneficiary or beneficiaries) inherits. Planning with this option in mind allows a family to assess and respond to the actual financial needs of the family after the death of the first spouse. The surviving spouse always has the option to choose not to accept the inherited IRA and disclaim the entire interest or a portion of interest in it.

In most states, the surviving spouse has nine months to decide whether or not to accept, disclaim, or partially accept and partially disclaim his or her interest. In order to have a qualified disclaimer under federal law, the disclaimer must be irrevocable, unconditional and in writing. The written disclaimer must be delivered to the owner of the interest or the owner's legal representative. The disclaimer must be received no later than nine months after the date of death or nine months after the disclaimant attains age 21, whichever is later.

The one disclaiming cannot have accepted the interest or any of its benefits, and it must pass to the contingent beneficiary without any direction on the part of the disclaimant. The property must pass to either the spouse of the decedent or to a person other than the person making a disclaimer.

Avoid This Mistake

The death of a spouse is an emotional time. It's easy to make big mistakes when in an emotional state. After a death, if the named beneficiary is even considering a disclaimer, the most important thing is to do nothing! The surviving spouse should not take control of the assets. The assets should not be transferred into the surviving spouse's name until a final decision has been made not to disclaim any portion of the account.

A disclaimer offers several advantages. If the surviving

Summary: RETIRE SECURE! PAY TAXES LATER

spouse disclaims to the children as contingent beneficiaries, the IRA is not included in his or her estate, which could reduce estate taxes for the children at the spouse's death. Also, the minimum required distribution of the inherited IRA would be based on the children's life expectancy rather than the shorter statutory joint life expectancy of the surviving spouse. Longer life expectancy equals longer tax deferral.

In many cases the best solution will be for the surviving spouse to keep a portion of the IRA and disclaim the remainder. The beauty of the disclaimer is that the decision can be made after the death of the first spouse when a clearer picture of the surviving spouse's financial situation is available. ●

The Ideal Beneficiary Designation For Your Retirement Plan

Wills or trusts do not control the distribution of an IRA or retirement plan on their own. Distribution is determined by the beneficiary designation. A trust can be named as a beneficiary and thereby control distribution, but many people have trusts and have never changed their beneficiary designation to that trust.

The problem with beneficiary designations and disclaimers is that there are too many variables and we cannot predict which ones will be relevant at the time of death. Who knows how much money will be left at the first death, or who will die first? What tax laws will be operative in the year of the first death? What will the surviving spouse need? The solution may be Lange's Cascading Beneficiary Plan™ (LCBP™).

How LCBP™ Works

LCBP™ takes the layering of beneficiaries through the use of disclaimers to a new level of sophistication. It recognizes the importance of providing for the surviving spouse while also keeping options open.

Typically, to take full advantage of LCBP™ and preserve the surviving spouse's options, the IRA owner should name primary and contingent beneficiaries to their IRA according to the following hierarchy: 1) the spouse; 2) a unified credit shelter trust; 3) a child (or the children equally); and 4) a well-drafted qualifying trust for a grandchild (or grandchildren).

In a perfect cascade, the surviving spouse could retain some of the participant's IRA, roll it over into his or her own name, and appoint his or her own beneficiaries. He or she would also have the option to disclaim a portion

to a credit shelter trust or to an adult child who could then use his or her own life expectancy for minimum required distributions purposes.

At that point, the adult child could retain some of the participant's IRA and take minimum required distributions and/or disclaim a portion to the trust for his or her own child who could then use his or her own life expectancy for MRD purposes. The bulk of the IRA could be tax-deferred for generations!

Using a trust as the potential beneficiary of a retirement plan and/or IRA can be an excellent method of protecting the beneficiary. Creating trusts for minors, trusts for spendthrifts and trusts for spouses can be appropriate under certain circumstances.

Having a flexible estate plan and cascading beneficiary designations provides the surviving spouse with multiple options for distributing the inheritance based on the family's circumstances at the time of the first death and regardless of ongoing changes in the tax laws. By incorporating the cascade into an estate plan you give yourself the best chance to "stretch" an IRA and pay taxes later. ●

Doing Well By Doing Well

Some people have charitable intentions and, regardless of any tax benefits, they plan on giving large amounts of money during their lives and at their deaths to worthy charities. Most people, however, also appreciate it when Uncle Sam subsidizes those charitable intentions. Some simple planning can provide great value to the charity, great value to your heirs and eliminate or at least reduce funds going to the IRS.

Which Dollars to Leave Charity

Charities don't care in what form they get their donations because they do not pay income taxes. Individuals do care because of the different tax ramifications.

Assume, for example, that you have an estate consisting of \$500,000 in an IRA and \$500,000 in after-tax money and that you want half to go to charity and half to your heirs. It would make sense to give the IRA to charity unless the beneficiary is 40 or under and would benefit from a stretch IRA. That young beneficiary could enjoy many years of tax-deferred growth.

On the other hand, if the IRA is left to charity, no one will ever have to pay income tax on the IRA or its growth. Roth IRAs are the worst assets to leave to charity, but the best asset to leave to an heir because distributions are tax-free — a tremendous benefit to an individual, but meaningless to a charity. ●

· Book 30 of 44 ·

Summary



The Rules for Turning Patterns Into Profit

The 10 Essentials of Forex Trading

THE SUMMARY IN BRIEF

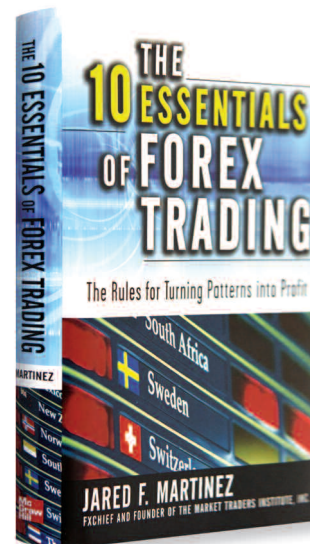
In *The 10 Essentials of Forex Trading*, currency trading expert Jared Martinez shows how to use charting methods to effectively relate market movements to trading patterns. Though written primarily for traders, there are lessons within Martinez's mentoring approach to Forex trading for anyone in quest of personal and financial success. Martinez pronounces that success will be determined by how confident you feel, what you think and how you respond when bad things happen. In his words, "In any financial or business endeavor, success starts in your head, is fueled by your heart and the results are driven by your actions."

To trade the Forex market, you must come to the trading table well prepared with skills that include knowing how to choose and use the right trading tools, how to trade in buy and sell zones, and how to identify trends and trendlines. You will also need to be prepared for what the market demands the most — change and discipline.

Martinez introduces the tools and mind-set necessary to reap personal and financial reward. By following his rules for turning patterns into profit, no matter what your level of trading experience is, you can develop the skills you need to become a consistently successful foreign currency trader.

IN THIS SUMMARY, YOU WILL LEARN:

- The importance of developing a solid personal and trading constitution.
- How to use Japanese candlesticks to discern the sign language of the market.
- How to create entry and exit strategies.
- How to forecast and trade a sideways movement in the market.
- The importance of trends: finding and using them to your advantage.
- How to become a confident, competent and profitable trader.



by Jared F. Martinez

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THE COMPLETE SUMMARY: THE 10 ESSENTIALS OF FOREX TRADING

by Jared F. Martinez

The authors: Jared F. Martinez is the founder and CEO of Market Traders Institute Inc., where his primary focus is to teach novice investors as well as experienced traders how to effectively take advantage of the markets.

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Introduction

Forex, or the foreign exchange market, offers incredible financial opportunity for those who are ready for the adventure, but it can be disastrous and financially devastating for those who are unprepared.

No one can become successful at trading without first establishing his or her personal constitution. It is this aspect of yourself that either destroys you or allows you to succeed in life and that includes Forex.

What the market demands most is change and discipline. If you cannot find the courage to change and then remain disciplined to that change, you will be unable to develop a trading strategy that aligns with your personality and your perception of life.

The “holy grail” is knowing when to get in the market and why, and *when to get out and why*. If you can learn the when and the why, you will be able to make market movements work for you.

If you are going to be successful at trading, you will need to acquire a trading strategy that is easy to execute, easy to understand, easy to obey and that works for you consistently.

Remember that man was not created just to get by; he was created to reach his highest potential. ●

So You Want to Trade Forex?

The first step to successful trading is to ensure that you are not bringing your bad habits to the trading table. Creating your personal constitution is like acquiring the best helmet possible to protect your most important asset — your mind. Your mind is the epicenter of your body and the control tower of your destiny.

• **Are you more honest than dishonest?** Telling the truth is critical; it prevents future trading missteps.

• **Are you a promise keeper or a promise breaker?** If you are not a promise keeper, you will bring this bad habit to the trading table and you will not follow the rules as you trade.

• **Are you a rule maker or a rule breaker?** Being successful at trading requires that you follow certain rules. Otherwise, you will be driven by your emotions and will be caught up in chasing the market, changing your mind and breaking every rule in the book in the spirit of trying to save yourself.

• **Are you a good or a bad listener?** The greatest reward comes to those who develop the art of hearing what is not said. As the market moves, it “tells” a story. You cannot find success in trading by disrupting the flow of the market’s conversation.

• **Do you think before you speak or speak before you think?** As a trader, you must engage in conversation with the market, and your response can be either ignorant or intelligent. If you insist on speaking before you think, the market will allow you to prove your ignorance.

• **Do you think before you act or act before you think?** You will need to get in the habit of thinking of all the details potentially involved in a trade. You will need to have checklists. You will need to get in the habit of creating a trading plan and maintaining the discipline of trading your plan. That habit forces you to think before you act, avoiding impulsive, emotional actions that generate unsuccessful trades. The market has no remorse for ignorance and impulsive action.

• **Do you manage your emotions or do your emotions manage you?** When it is time to trade, the more you rely on your emotions, the more money you will lose. Successful traders manage their emotions; unsuccessful traders let their emotions manage them.



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Rebecca S. Clement, Publisher; Sarah T. Dayton, Editor In Chief; Athena Nicolaides; Art and Design, Rachel Siegel; Contributing Editor

Summary: THE 10 ESSENTIALS OF FOREX TRADING

- **Are you responsive or reactive?** When it comes to any crisis, you owe it to yourself to respond logically, not emotionally. Reactive trading will cause you to lose all your money, whereas responsive trading will allow you to think through your next move and take advantage of the next opportunity that knocks.

- **Is your ego more constructive or destructive?** The market will teach the destructive ego the true definition of humility. The constructive ego, through humility, will in the end fight to be happy rather than right.

- **Are you more positive about life or more negative?** If you want to become a successful trader, you will have to purge your negative attitude and adopt a positive mind-set.

- **Do you fear your mistakes or do you embrace them and learn from them?** You must pay attention to your mistakes and embrace them with a positive attitude.

- **Do you focus on what you have or on what you have lost?** All traders lose money and make money as they trade. Successful traders spend no time worrying or thinking about their losses; they stay focused on the next opportunity.

- **Are you a goal setter or a goal quitter?** Traders who set goals and persist until they succeed reach their pot of gold: executing trades correctly 100 percent of the time and consistently making more money than they lose.

Developing a solid personal and trading constitution is the first step toward successful trading on Forex. What good are technical skills without courage? What good are trading rules if you are a rule breaker? Why learn to take advantage of new trading opportunities if you cannot let go of your past mistakes and failures? ●

Introduction to the Forex

Forex is an acronym for *foreign exchange*, a market where people exchange the currency of one country for the currency of another in order to do business internationally. Forex is also called the *cash market* or *spot inter-bank market* (trading on the spot, at whatever the price is at that moment).

Prior to 1994, the Forex retail market for small individual speculative traders — those looking to make a profit on price movement and not looking to hold onto any currency long term — was not available. In the late 1990s, retail market-maker brokers were allowed to offer individual traders the opportunity to participate in the Forex market as we know it today.

Forex is considered the largest financial market in the world. More than \$1.5 trillion is traded daily on the Forex, exceeding the daily combined activity of all the other financial markets.

Although Forex trading is commission free, there still is cost involved. That cost is called the spread, which is what you get charged to access the Forex market. The spread is the difference between the buy price and the sell price of a specific currency.

There are spreads between all currency pairs traded, and they average 3 to 6 price interest points, or pips, on the major world currencies (the U.S. dollar [USD], the British pound [GBP], the Japanese yen [JPY], the European euro [EUR] and the Swiss franc [CHF]). The value of a pip averages around \$10. Currencies from small countries are called *off-brand currencies* and can have spreads of as much as 500 to 1,000 pips.

A trader's financial reward is measured in pips, which are then converted to dollars. Most traders on the Forex trade with leverage, borrowing a broker's money to trade. You acquire leverage by posting a bond or deposit with a Forex broker who then allows you to trade using the broker's money. There are typically two types of lots: a \$100,000 unit is called a *regular lot*, and a \$10,000 unit is called a *mini-lot*.

There are four types of orders:

- **Market orders:** to enter or exit at the current market price,

- **Limit orders:** to enter or exit the market at a predetermined price,

- **Stop orders:** similar to limit orders, they turn into market orders when the market reaches the predetermined price. A stop order is when you place a buy order above the current market price or when you place a sell order below the current market price.

- **OCO orders:** (one cancels the other order) to cancel exposure after either your stop or limit has been filled and you have been taken out of the market.

Understanding all successful trading procedures and rules before you trade is essential. You must practice them over and over again until they become unconscious practices. ●

Self-Empowerment via Trading

You must be taught to use the best tools available. The most important thing about a trading system is that it must be simple and easy to use. It must be able to find the current market direction, have a consistent

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entry strategy, and have two very clear exit strategies — one for protecting against major losses and one for capturing profits.

Indicators and oscillators (which are nothing more than mathematical equations for monitoring price movement against time displayed via lines on a chart) are one way to determine market direction. Using trading indicators eliminates a lot of guessing and allows you to develop a trading strategy that works consistently within a time frame that suits your personality.

Most traders make their money during trends and lose it when the market gets turbulent or begins to go sideways.

Use indicators to make your exit decisions. Keep your exit strategy simple, and trade using smaller time frames: as a beginner, perhaps 30-minute, 15-minute or 10-minute time frames. Your aim should be to establish the habit of winning more than you are losing. After that, you will be able to move to a larger time frame to capture more pips, and you can start learning more advanced exit strategies.

A confused mind is going to take you down a path of financial destruction. Stay clear from using too many indicators or complicated indicators. Keep it simple! ●

Trading Japanese Candlesticks

There are three types of charts traders can refer to: a line chart, a bar chart and a candlestick chart. Until recently, bar charts dominated, but now even the world's top traders are using Japanese candlestick charts.

Japanese candlesticks communicate via certain formations the future potential moves of the market. This visual language indicates clear buy and sell signals, communicating to the trader when it is time to enter a market or get out. Candlesticks monitor price movement against time, providing traders with four key pieces of information for a specific time period: the opening price, the closing price, the highest price reached and the lowest price reached.

A *high* is defined as a level where the market ceases to rally and turns in the opposite direction. A high can be considered a new level of resistance, or a higher price level achieved by the bulls that was interrupted and reversed by the bears.

A *low* is defined as a level where the market ceases to drop. A low can be considered as a new level of support, or a lower price level that was achieved by the bears and then interrupted and reversed by the bulls.

Learning how to identify and trade candlestick formations can be extremely useful in identifying potential coming patterns. However, you should not trade these candlestick patterns on their merits alone. Success is increased if you have more than one educated reason to enter the market. ●

The Financial Game of Support and Resistance

Forex trading is a game played on a daily basis by two teams, or two types of investors on opposite sides of a trade. The bulls want the market to go up. The bears want the market to go down. The two sides are in constant, unrelenting battle, fighting for control of the trading territory. Like any game, there are objectives, rules and penalties. Each side is trying to get ahead by scoring points, following the rules of the game. You must obey the rules if you are planning to succeed in trading.

Bulls and bears fight aggressively to make the market go their way. There must be someone buying and someone selling simultaneously. In other words, one trader must be a bull going long and one must be a bear going short. Both are adamant about their positions, despite the fact that they are relying on extremely accurate information, often from the same sources. What is amazing is they are adamant about the market going in opposite directions.

Bulls and bears enter the market buying or selling in hopes that more bulls or bears will enter after them — creating a greater rally or greater dip.

Resistance and Support

As bulls and bears make new highs and lows, levels of support and resistance are registered. *Support* occurs when traders begin buying, supporting a price as it is falling. Conversely, *resistance* occurs when traders feel prices are getting too high or expensive, and they resist buying at that price.

As traders support a currency at a certain price, a new low is created, and when they resist buying, a new high is created. Buyers want prices to go lower so they can get a better deal, and sellers want prices to go higher to enable greater profits.

Resistance occurs when the bulls move the market to a new high and the bears jump in aggressively selling, attracting more sellers than buyers, interrupting the rally, and creating a retracement or pullback from the high. The new high becomes a new level of resistance, defined

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as a price level where bears start selling enough to interrupt and reverse a rally.

Support occurs when bears move the market to a new low and the bulls jump in aggressively, buying to support the price and attracting more buyers than sellers. That increased buying interrupts the dip and creates a pullback from that low. The new low becomes a new level of support, which is where bulls start buying enough to interrupt and reverse a dip.

Most successful traders are more focused and more comfortable trading midway of a price swing, rather than going to extreme lows and highs in pursuit of profit. Knowing where the projected highs or lows will be will allow you as a trader to know when it is time to get in and out of the market.

The major levels of resistance are the targets the bulls will be aiming for if they are in control or if they take back control from the bears, establishing a new high. Then there is typically a pullback, because traders that take short positions most of the time place their protective stop-loss orders near the last highs; so when the bulls hit that area, there are a lot of buy-stop orders and a lot of selling. Bulls succumb temporarily, bears start to gain a little and a pullback takes place. Bulls will step in and support a price near a past level of support or near an uptrend line.

If the past level of resistance is penetrated and the uptrend is going to stay in place, the bulls will step in and start buying heavily near the last low. The first level of support becomes a great area to go long in the market. ●

Learning to Short the Market

Bears want to take the market to lower levels, enabling them to sell high and buy low. This is called *shorting the market*, or *going short*. To avoid making losses, it is important to know how to identify those potential targets the bears are aiming for — the major levels of support — if they want to take control from the bulls. This happens when the market reaches a past level of support and establishes a new low. Then there is typically a pullback, because traders that take long positions most of the time place their protective stop-loss orders near or at the last lows, meaning that when the bears hit that price point, there are a lot of sell-stop orders and a tremendous amount of buying taking place. Bears succumb temporarily and bulls start to gain a little territory, and a pullback and a small rally takes place. Prices will continue to rally until the bears

step in and start selling again near a past level of resistance or near a downtrend line.

If the past level of support is penetrated and the downtrend is going to hold, the bears will step in and start selling heavily near the last level of resistance. The first level of resistance becomes a great area to go short in the market.

As bulls and bears continually play this game, bulls try to make higher highs and bears try to make lower lows. As the market moves up, many times past resistance can become future support and becomes a great place to buy. As the market moves down, many times past support can become future resistance and becomes a great place to sell.

Trading is a game. The way to learn how to win at this game is to work at it. ●

Trends and Trend Lines

As the market moves, it will move in only one of three directions: up, down or sideways. When it moves in any direction, it waves.

Spotting an Uptrend

If the market is going to move up or trend up on any time frame, it will wave up, creating higher highs and then wave back down, creating higher lows. At some point the trend will end, but until it ends, most successful traders try to take advantage of the move and take the ride up until it bends or ends.

As the market trends in any direction, it moves at different speeds. Most trends travel at a 45-degree angle as they move; that trend line is called the *outer trend*. When a trend moves at a slower pace, a long-term trend line is created. When a trend moves faster, it creates what is called an aggressive trend, or the *inner trend line*.

If any current trend is going to stay in place, once it retraces back to a trend line, the market will bounce in the direction of the previous trend, and the trend line will act as an obstacle that will change the direction of the current movement. In other words, correctly drawn trend lines can project future levels of potential support in an uptrend and future levels of resistance in a downtrend.

Successful traders constantly monitor all uptrend lines on all time frames. Outer trend lines represent the overall movement on the chart for that time frame, and the inner trend line represents the most recent movement.

Uptrend lines act as future levels of support. They are like a floor, and when the market hits the floor, it usually bounces back up.

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If the inner trend line is broken, the market usually moves to the outer trend line. If the market breaks the outer trend line, the market will predominantly move to the long-term trend line and bounce back up from there. If the long-term trend line is broken, as a rule there will be a major reversal.

Finding Downtrend Lines

In a downtrend, the market reacts the same way as in an uptrend, but in the opposite direction. That means all the rules are the same, but in the opposite direction. Instead of the market making higher highs and higher lows as it trends up, it makes lower lows and lower highs as it trends down. The market bounces down on a downtrend line, creating a level of resistance.

Downtrend lines act as ceilings for the market and are future projected levels of resistance. If the inner downtrend line is broken, the market usually moves to the outer downtrend line and bounces back down from there. If the market breaks the outer downtrend line, the market will generally move to the long-term downtrend line and bounce back from down there. If the long-term line is broken, as a rule there will be a major reversal.

Trading Channels

As a trend moves, it likes to move inside a trading channel, which is described as the market moving at an up or down angle inside two trend lines that create somewhat of a channel. The trend lines of the trading channels act as both resistance and support. Trading channels can shift.

The value of trend lines is that using them as part of your trading system and in conjunction with other indicators increases your chances of success. This is because of convergence. Where there are several things taking place at a single price point, having several indicators could confirm and support trading decisions. Trend lines are just another little piece of the puzzle that indicate a continued move. The key is to always look for that convergence, along with a trend line bounce in the direction of a trend. ●

Buy and Sell Zones

Trend lines divide buy zones from sell zones. When the market is trading above any trend line, it is in the buy zone and traders are looking for the best location to buy the market. When the market is below the trend line, traders are looking for the best location to short the market. When a trend line is broken, a trader may want to reverse position.

When the market breaks the uptrend line and enters into the sell zone, always take the time to check the angle of the trend line. The backside of the uptrend line will now act as resistance. Should the market begin to rally again, it will need to break through the backside of that trend line or resistance. If the backside of the trend line is lower than the last high, there is an 80 percent chance of a continued dip and a trend reversal. If the backside of the trend line is higher than the last high, there is an 80 percent chance of a continued rally.

The strongest sign of a reversal, or that the uptrend is dead, is when the market retraces back to the latest level of major support.

The buy zone works exactly the same as the sell zone, but in the opposite direction. When the market breaks the downtrend line and enters into the buy zone, always take the time to check the angle of the trend line. The backside of the downtrend line will now act as support. Should the market begin to dip again, it will need to break through the backside of that trend line of support. If the backside of the trend line is higher than the last low, there is an 80 percent chance of a reversal and a new rally. If it is lower, there is an 80 percent chance of a continued dip.

The strongest sign of a reversal, or that the downturn trend is dead, is when the market retraces back to the latest level of major resistance.

Knowing about buy and sell zones can significantly aid your trading success; however, not all trend-line breaks offer trading opportunities. Not all trends are clear, and not all buy and sell zones are clear. If the market does not look clear to you, stay out. ●

Fundamental Analysis

The news that comes out about a country, good or bad, is called a *fundamental announcement*. Countries and companies both have fundamental announcements, which have similar effects on the value of a country's currency as on a company's share price. When investors get nervous and want to move their money from one country to another, they create a buying frenzy around the currency they are acquiring, driving the value up and creating a selling frenzy around the currency they're selling, which drives the value of that currency down. If the masses start selling more than buying — stock or currency — the prices will be driven down.

In the currency market or on the Forex, each country has approximately 20 major fundamental announcements annually for investors to monitor. Most economic reports

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are created monthly, quarterly or yearly, but some are created weekly.

Trading days are days when there are no fundamental announcements. Currency charts typically move 60 to 90 pips, depending on the currency.

Trending days are fundamental announcement days, when the market will generally take off in a direction after the announcement and move 120 to 240 pips within the first five hours, incurring a major price change.

Novice traders prefer trading days as the market is typically more predictable. Expert traders, however, prefer trending days over trading days because they can make more money in less time.

World Economies

There are three major world economies and time zones that traders monitor: 1) the Asian market; 2) the European market; 3) the U.S. market. The sun doesn't set on the financial markets of the world. Somewhere in this world, a financial market is open during any given 24-hour period.

Tracking down the fundamental announcements before you trade is critical. Make it a habit to see if there are any major fundamental announcements about to take place that may create volatility. ●

Consolidating, Bracketing, Accumulation or Sideways Movement

The market can only move up, down or sideways, which is commonly referred to as *consolidation*. Believe it or not, the market consolidates 50 to 60 percent of the time and trends the remainder of the time. You really need to trade two different trading systems: one that spots trends and allows you to take advantage of them, and one that spots consolidations and allows you to take advantage of them.

Consolidation Factors

There are two primary reasons why a market starts to consolidate, accumulate, bracket or go sideways. The first is when the world is waiting for a fundamental announcement and traders stop trading in anticipation; the market begins to consolidate in a tight trading range. The second reason the market may consolidate could be due to a country intervening and wanting its currency to trade within a certain trading range for economic reasons.

U.S. Fundamental Announcements

Fundamental announcements have an effect on every country's currency in some way, either immediately or soon after. The following fundamentals are announced in the United States:

- **Purchasing Managers Index**, indicating an expanding or contracting factory sector
- **Consumer Confidence Index**, monitoring consumers' attitudes and expectations regarding economic conditions
- **Consumer Price Index**, also known as the cost-of-living index, measuring changes in consumer prices
- **Durable Goods Orders**, a government index reflecting strength in demand for U.S. manufactured goods
- **Employment Situation**, listing non-farm payroll jobs, the unemployment rate, average hourly wages, and the length of the average workweek
- **Non-farm Payroll Indicator**, the greater the increase in employment figures, the faster the economy will grow
- **Existing Home Sales**, measuring the selling rate of pre-owned homes
- **Gross Domestic Product**, measuring the performance of the U.S. economy by measuring its production output
- **New Home Sales**, measuring new home sales and considered indicative of consumer spending generally
- **National Manufacturing Activities**, as reported by the Philadelphia Fed
- **Producer Price Index**, indicating the underlying inflation trend
- **Retail Sales**, considered to be the timeliest indicator of broad consumer spending patterns
- **Balance of Trade**, measuring the difference between imports and exports of U.S. goods and services

There are three trading strategies to use when the markets are consolidating, accumulating or bracketing.

Strategy 1

During periods of consolidation, traders will look to sell at resistance or near the highs. When prices get close to resistance, most traders turn to smaller time frames and look for confirming bearish Japanese candlestick formations near the highs and then short the market after the bearish formation appears. The bearish

candlestick formation gives confirmation that the market is about to U-turn. They then turn back to a larger time frame and look to find support on the other side of the consolidation trading range, taking the ride back down to support.

When prices get close to another level of support, once again traders will look to confirm their decision to buy and look for bullish Japanese candlestick formations near a level of support or a prominent low. They will enter going long after the bullish formation appears.

Once you find consolidation, it is hard to get hurt — as long as you have the patience to wait for the bearish candlestick formation to appear near the level of resistance and a bullish candlestick formation to appear near a level of support.

Strategy 2

This strategy will work provided your broker will allow you to trade this way. The *straddle* was designed for trading in tight trading ranges in anticipation of a fundamental announcement. It is very important that there is a fundamental announcement to be released and the market range is between 20 and 60 pips. In order to trade a straddle effectively, the market needs to create a tight level of consolidation before the announcement, which, in turn, will provide a straddle opportunity.

Strategy 3

Should you spot consolidation, rule No. 1 is to check to see if there is a fundamental announcement in the near future. If there are no fundamental announcements, then go ahead and trade in the direction of the current trend. ●

Bull and Bear Traps

After consolidation has formed and there are no fundamental announcements, *bull traps* are false breakouts to the south of that consolidation, doing nothing more than fulfilling the natural numerical sequence of the market.

Bear traps are the opposite of bull traps. After consolidation has formed and there are no fundamental announcements, bear traps are false breakouts to the north.

Currencies may aggressively react to fundamental announcements or they may not. Successful and educated traders respond, rather than react, to those announcements. They are well prepared and ready to switch from being a bull to becoming a bear at the drop of a hat. ●

Learning the Rules of Equity Management

As you learn to trade, never forget rule No. 1: *Protect yourself at all times* — this is vital to your financial survival. Protecting yourself as you trade is called placing a protective stop-loss order in the market at the same time that you execute the trade. Protecting yourself as you trade involves quantifying how much you are willing to lose ahead of time before you enter the trade and how much you will be able to emotionally and financially survive without that loss affecting your life and your financial security.

Trading without a protective stop-loss order ignores the potential damage the market can do to you. Events that move the markets 500 pips in a direction don't happen every day, but surprise fundamental announcements happen all the time.

The rule of survival at trading is never to risk more than 5 percent of your equity on any given trade. Do not stay focused only on the potential gain. You need to stay focused on the potential risk when making any trade. The reason you need to risk only a certain percentage of your trading margin is so that you have staying power in the market.

There is no need to ever sell the farm for any given trade. Your habit of success must be that for every dollar you risk, you must plan to make 1.5 times the return.

Savvy investors have one major focus: the preservation of their initial capital. They already know the price they had to pay to get that money. They are not driven by greed, and they don't want to re-earn the principal again. They first look at risk, then at the consequences of taxes and lastly at the potential of returns. ●

The Final Analysis

The only difference between successful traders and unsuccessful traders is that the unsuccessful ones don't know what they are doing and keep losing money in a desperate attempt to get it all back.

Successful traders know exactly what happens when they lose money and how to put it in perspective. They don't desperately chase the market, trying to make up for past losses. They don't waste any time dwelling on the past, rather; they stay focused on what future trading opportunities exist — and that is what makes them successful. ●

· Book 31 of 44 ·

Summary



Insights on Succession, Cohesion, and Legacy

The Dilemmas of Family Wealth

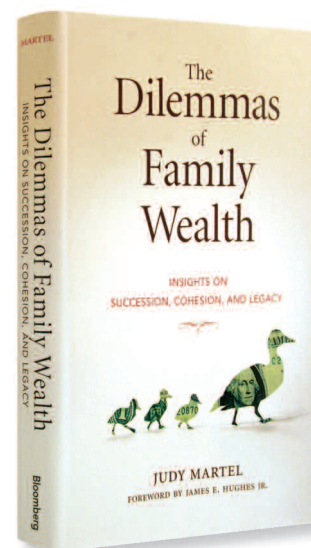
THE SUMMARY IN BRIEF

Successful families are those whose members understand that preserving the family is a precursor to preserving the family's wealth. So many go from "rags to riches to rags" because they don't communicate, they don't elucidate a set of collective values, and they don't educate future generations on how to handle wealth. When a family understands its common purpose, its members are able to build a legacy that is inclusive and supportive of individual, as well as family goals, further strengthening the unit for the current generation, as well as its subsequent offspring.

Judy Martel's *The Dilemmas of Family Wealth* recognizes the power of money to enhance or distort a family's destiny. Her research has revealed the many ways this circumstance plays itself out as each generation deals with the opportunities and burdens of wealth. In this summary, she shows how to recognize and understand the dilemmas that affect families' well-being and provide considerable hindrances to sustaining wealth. If a family makes the right decision in any of these situations, it can overcome many obstacles and enjoy success across multiple generations. If it makes the wrong decisions — and plenty do — the family will find its greatest blessing (financial capital) can also be its greatest curse.

IN THIS SUMMARY, YOU WILL LEARN:

- How to let go of a business.
- How to keep future generations connected.
- How to bring up future wealth generators.
- How to keep the family together.
- How to integrate new family members.
- How to prepare future generations to handle wealth.
- How to plan an estate.



by Judy Martel

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THE COMPLETE SUMMARY: THE DILEMMAS OF FAMILY WEALTH

by Judy Martel

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Succession and Letting Go of A Business

The Dilemma: It's time to plan for succession, but I don't know how to let go of the business.

Succession is surrounded by emotions that touch every part of a business founder's existence and that of his family, yet he must plan for and accept change — the long-term survival of his business and fortune depends on it. There are many ways to relinquish control — the key is for the founder to set up a vision for the future, but allow the next generation to modify it and live out its own dreams. The melding of family and business goals is one of the key benefits of having a family business, but the same business ties that bind may choke if pulled too tightly by the founder.

Failing to Transition

Most businesses fail to make a successful changeover from one generation to the next. Succession planning is crucial for families seeking to pass on the company they have spent a lifetime building. If the business fails between the first and second generations, the family will likely lose its wealth. A rift in the family can also result if the transition is handled poorly. Though unfortunate, it is quite often the case that many people do not know how to plan so that both the family and the business remain intact.

Often, the fear of letting go drives founders to make decisions that are inconsistent with what makes sense for the business. Creating a succession plan that removes that fear will go a long way toward resolving any lingering issues of trust. However, many succession plans fail because the first generation tries to impose its dreams on the second, setting up a cycle of dysfunction and collapse.

Another reason successions fail is the founder's failure to follow through with a process for the transition. The founder might wish (or even insist) that the successor continues to run the business as he himself would. The first item on any succession agenda should include a process and policies that help the founder overcome his worries and enable both him and the successor to trust each other.

Choosing a Successor

The first and second generations often find difficulty predicting how successful a succession plan will be. While the original players (the first generation) are still active and in control of the business, there is no family history of transition on which they may draw. Initial optimism can easily give way to frustration as unanticipated challenges stall succession decisions.

One option to consider is allowing the company's board of directors to resolve the issue based on policies previously set by the board and the family. This provides a much-needed method for "letting go" of the business. While it takes time and careful thought to establish such a set of policies, it is worth the effort because the policies will continue to help guide decision-making, particularly the messy decisions that typically accompany being both a family and a business. Some policies to consider include the following:

- **Mission and vision for the business.** These keep both the family and business on track.
- **Method for communication.** Set the method and time to disseminate information.
- **Procedures for hiring family and non-family.** Objective standards for hiring are invaluable, particularly when applicants must be turned down.



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Rebecca S. Clement, Publisher; Sarah T. Dayton, Senior Editor; Robert J. Smith, Senior Contributing Editor; Joanne Merenda, Graphic Designer

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- **Compensation guidelines.** Objective guidelines keep people from feeling cheated.
- **Performance reviews.** Include specific criteria and a path for advancement.
- **Training programs.** Never assume that employees have “soaked up” the business just because they’re family.
- **Communication with shareholders.** Communication should include people in the family who are not active in the business.
- **Philanthropy and community service.** What is the company’s vision for a legacy?

Aiding the Succession

The first and second generation can work together to ensure the business transitions successfully. The post-succession period is a critical juncture for family business success because a new operating model has to be instituted. The business is likely being led by a partnership of siblings, often with one of them in a leadership position. Decisions can no longer be made by one person — collaboration is the key to success. The family must take stock of its business as it moves forward in order to throw its full effort into aiding the succession.

Going Public

Family businesses don’t always stay in the family. Sometimes the family must relinquish full control of the business and move to outside leadership for any number of reasons (the business grows too big for them to handle or competition becomes too tough or the nature of the business changes). Families must realize the shift in dynamics that occurs when the business goes from being a family concern to a more impersonal professional situation.

Families can, however, retain influence and control over the company even if outside assistance is brought in, as long as the family still maintains a controlling ownership of the company. ●

Keeping Future Generations Connected

The Dilemma: I sold my business at the right time and have more than enough to take care of my family, but I feel alone and uncomfortable in my new position of wealth. What do I do with my time, and how do I preserve a connection with the family wealth in subsequent generations?

After building a successful business or two, the role of

bystander can seem formidable for ambitious, Type A personalities. Founders who still possess the energy and drive they used to build their business must find a new outlet for that energy and drive. The next generation has also lost some of its connection to the family identity and must write its own chapters in the family narrative.

The entire family is seeking a new identity. It has wealth it can use to enrich the dreams of everyone, but first it must understand the transition it is going through and take steps to preserve its family heritage.

Redefining the Role

Some founders find it difficult to slip into a quieter role once the family business goes public. Type A founders, who just can’t seem to stop, sometimes evolve into serial entrepreneurs, starting new and different businesses because they can’t envision a life without the structure that being a leader requires. The hardcore entrepreneurial founder who doesn’t want the regimen of running a new startup can turn to mentoring to provide next-generation entrepreneurs with the benefits of his experience and wisdom. Those founders who prefer to veer away from the company life will find a range of pursuits outside the business world — mentoring others, getting involved in managing their own portfolios, or serving on boards.

Still others keep active in family concerns, instilling the family legacy of values that are focused on providing a healthy and supportive environment for future generations. Experts applaud such an approach to preserving the family narrative.

Remembering Other Family Members

The entire clan is adjusting to the loss of the family identity and is contemplating what its next move might be. This is a perfect time to form a family council, if one is not already in place.

A successful family council coordinates wealth with the family’s relational estate (its history, heritage, interpersonal relationships, etc.) across the generations. The family decides who will be on the council and proceeds to define it and decide what to do with the wealth. Deciding how to manage the family’s wealth is but one opportunity for the family council to be active — it can also guide the family’s pursuit of charitable interests, new businesses, and how to transfer wealth to future generations.

Keeping the Past Alive

After the company is out of the family, either because

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Family Ventures and the IRS

The Internal Revenue Service will calculate imputed interest if it deems a loan among family members to be interest-free, or if the interest rate is unusually low. The lender will be responsible for the taxes due on the phantom interest income. If there is no interest charged, the IRS will treat the phantom interest as a gift and apply it toward the lender's annual gift tax exclusion.

it has been sold or has gone public, the final challenge is preserving the family history for future generations who played no part in building the wealth. Sometimes it is the retired founder who takes on the task of compiling this history. Other times, it is someone a generation or two removed from the business, who understands and appreciates the value of what was accomplished and seeks a way to keep the legacy alive. ●

Future Wealth Generators

The Dilemma: As the family grows, the original family fortune is not enough to support everyone. How can I support and encourage future wealth generators to add to the family coffers?

As many founders toiled to make a better widget, they dreamed of intellectual professions for their progeny — lawyers, doctors, professors, and the like. What some founders fail to take into account is that future business entrepreneurs are vital for wealthy families. While the family begins to write a multigenerational narrative that will be funded through the wealth created by the founder, the money is being stretched to pay for more members who come into the fold.

Quite simply, new family entrepreneurs are required to replenish the financial capital. Rising family entrepreneurs have access to the original base of financial capital, and shrewd founders will realize that this capital can benefit the family “bank” and fund the development of future generations. When families lend to their own, they encourage and support the next generation in its dreams, even as they add to the family coffers.

Depleting the Fortune

Families often fail to realize how wealth is lost through generations when there is no crop of new family entrepreneurs to feed the fire. Consider this scenario: If you start out with \$100 million and have four kids, and they have four kids, you're down to one-sixteenth of the for-

tune per child. Assuming a 10 percent return, with 4 percent going to taxes and 3 percent to inflation, you can't spend more than 3 percent of your assets and still have any growth in your portfolio.

The numbers can get even worse if the family members fail to consider erosion to the original capital base as the founder moves from building a business to living off the capital. Additional expenses are incurred as the founder loosens the purse strings and steps up his lifestyle. That \$100 million can be cut considerably with the purchase of bigger homes, vacations, boats, and the like.

The immediate need is for an additional influx of financial capital. By making a financial loan or grant to one of its members, the family fosters its own growth as a whole unit, as well as that of its individual members.

Professionalizing the Process

Family venture committees, created for the purpose of investing in new family start-ups by lending money to entrepreneurs, are an effective way families can structure themselves to encourage entrepreneurial quests and increase financial capital. The committee convenes to set parameters for loans and guidelines for what is expected of applicants. The entrepreneur, or borrower, is responsible for providing regular business reports to the committee, including all financial information.

The committee should have a written policy for applicants to review so there are no surprises and no future accusations of being treated differently from another family member. The objectivity afforded by the written policy, as well as a written agreement regarding the specific terms of the deal, will help families preempt any emotional outbursts in the event the start-up crashes.

Mentoring the Next Generation

In the ideal situation, young would-be entrepreneurs learn business principles at the feet of the founder and later enjoy a mentoring relationship as the seeds of the new business yield success. The founder retains a valuable role when he leaves the business and his expertise will be appreciated by a new generation.

Families engage in different stages of mentoring and teaching as the next generation grows into its business roles. They may begin with teaching and coaching skills, and evolve into true counseling and mentoring roles. That evolution may take the following form:

- **Stage 1:** The first generation strives to create a work ethic and a sense of passion and drive in

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their children so they don't have a sense of apathy.

- **Stage 2:** The first generation helps the second develop skills and encourages them to see what is possible when they master these skills. Good communication is crucial — families cannot give mixed messages about what is expected of the second generation.
- **Stage 3:** When the next generation wants to go in another direction, with help from the family business, the decision-making process should include a board of directors, which will share with the family the responsibility of drawing up the rules around loans for new business ventures, as well as the appropriate review process. ●

Keeping the Family Together

The Dilemma: I want the wealth to enhance our dreams, but don't want it to be the only reason we stay together.

When family members argue about money, what they are really arguing about are their differing core values. If members of the family think their values are not being compromised, they're more likely to work toward the greater good.

Families must communicate regularly in order to build and transfer wealth, and do it from a base of common values. As obvious as it sounds to say that families need to talk, there are many reasons why it is difficult. Many families need a process to help them get started, to remind them to continue to communicate, and to provide a framework for how the family continues to work as a unit. Families must learn to communicate as a prerequisite for working together.

Meeting Face-to-Face

Family meetings can take different forms, depending on the unique needs of the family. Instituting family meetings at home is not difficult, but it does require some sort of format. Here are some tips for families who want to initiate family meetings:

- Everyone is an equal at family meetings and should be treated accordingly. Even young children deserve to be heard and to feel that their input is being seriously considered.
- Stick to the established time for family meetings (weekly, monthly, etc.) to help ensure commitment to them.
- Give everyone a chance to speak, but don't let the meeting deteriorate into a gripe session.
- Plan for some meetings to take place in recreation-

al settings to avoid negative association.

- Allow each family member the opportunity to be in charge of chairing a meeting.
- Compile a list of important issues to be discussed at each meeting.
- Practice good communication skills. Be specific. Avoid defensive postures.
- Practice good listening skills. Don't interrupt. Listen with an open mind and be certain you understand and are understood.

Guiding the Family

Once families have learned how to communicate and have unearthed their shared values through whichever type of meeting they prefer, they must then put those values into action by creating a mission statement — a written statement that outlines the way in which a family will live its values.

The mission statement is a point of reference for common understanding and a map for the family's future. It is an affirmative statement that reflects the values, commitments, and priorities of the family unit. As such, each family member should have input in making sure the family's common values are represented.

The mission statement should be considered a living document — just as the family's commitments and priorities might change or evolve over time, the mission statement would, in turn, change to reflect this. The statement should be revisited, reviewed, and talked about at family meetings, to keep it as current as possible.

Governing through Problems

Typically, when families look at situations that require structure, they get stuck in the emotional webs of one of three common governance crises:

- **When sibling rivalry provokes one party into refusing to participate in a family enterprise.** Even with a common set of values and a stated mission, families sometimes can't prevent one member from splintering off if he feels he's been mistreated. After all, until a crisis occurs, the family doesn't really have the opportunity to test its mission. When problems do erupt, it will help the family to regroup around its common values and reiterate the mission.
- **When a sibling needs to be fired from the family business.** When a family has to fire an unproductive member, it should be able to point to a policy as a guide for both gauging performance and carrying out the dismissal. The key to

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being able to remove an unproductive family employee is in the documentation — gathering a documented record of unsatisfactory performance and all attempts on the part of the family to help the person turn things around. Families should also remember to be generous in helping the fired individual find a productive new path, whether through sabbatical, education, career counseling, or even therapy.

- **Management of common property.** Whenever families own an asset together, there is bound to be disagreement about its management. Add in the sentimental value attached to the property and the discussions become tainted with emotion. To address these issues, families must communicate and set up a clear governance structure regarding how decisions will be made. This communication must be among all family members, in order to avoid disagreements now and in the future.

Preparing the Next Generation

With the family mission statement as a guideline for values, the young members of the family — the third or fourth generation — gain knowledge about how the family operates as a unit. As they mature, they can be included as nonvoting members on the family board of directors or participate in the family's philanthropic initiatives, putting the mission statement into practice and beginning to learn how to work within a family unit. ●

Integrating New Family Members

The Dilemma: As new members come into the clan through marriage, how do I level the playing field if one partner is less wealthy, and what value do certain structures like prenuptial agreements offer me?

Unequal wealth can be the cause of great discomfort in a relationship. Compounding the problem, if the wealthier partner hasn't come to grips with the family fortune, it becomes nearly impossible to create a union in which each partner feels on equal footing, much less united to the extent they can mentor the next generation.

Tension is created because, while the wealth of one partner can enable the new couple to begin writing a family narrative together, the unspoken implication is that the one with the money has the right to more privileges and a greater say in how the wealth is spent. Equalizing the power comes only when the couple reaches a mutual understanding about the wealth.

Understanding Emotions Concerning Money

Well before a financially unequal relationship becomes serious, a couple should discuss how each partner feels about the unequal wealth. That will provide the basis for moving forward. Fiscally unequal partnerships can work if couples disclose their expectations about money and then take the steps necessary to make them both feel they're on equal footing, whether those steps involve prenuptial agreements, annual gifting programs, or equalizing assets during estate planning. The couple must have a common understanding before committing to a structure.

Easing Discomfort

When couples hash out their philosophies about money, it becomes a relatively easy asset to divvy up in accordance with their mutual agreement. Placing the less wealthy partner on firm financial footing also enables that person to feel equal on other fronts; indeed, most experts suggest the wealthier partner provide the other with enough to promote a feeling of independence.

However, when a couple examines structures like prenuptial and postnuptial contracts, estate equalization strategies, and even informal agreements, they must be certain that form follows function. Too many lawyers are more than willing to slap a form on the table without urging the couple to go through the emotional work of discovering their philosophies about money and its effect on the relationship.

When partners discuss money, they may be speaking from their own perspective, but the key is to see it from the other person's viewpoint. Both parties must value what the less wealthy partner brings to the relationship.

Considering a Contract

Prenuptial agreements are among the most popular and effective solutions for many couples. While some consider them romance killers, they do provide a forum for disclosure at the outset of the relationship, when it is important to clarify matters of the wallet, as well as those of the heart.

Prenuptials are neither recent nor novel solutions to relationship-related financial issues. Throughout history, marriage contracts were commonplace in many cultures. Prenups remain one of the most popular contracts for couples looking to equalize their estates. Most attorneys agree that virtually everyone would benefit from a prenuptial agreement, in terms of protecting current assets, as well as future or anticipated wealth.

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Talking About Prenups

Talking about money in the context of a relationship breaking up is not easy, and to some it feels like a negative cloud over the pending celebration of marriage. However, time won't ease the discomfort, and when prospective partners know right off the bat how each feels, it will be less awkward. To ease the conversation, couples should choose a neutral environment, where both parties feel comfortable. Put all issues on the table (careers, schedules, duties, income, debts, anticipated inheritance, etc.). Full disclosure is important.

Although some couples feel that the most difficult element of a prenup is broaching the subject to their intended spouse, often the initial communication is only the first hurdle. Depending on the complexity of the agreement, the time it takes to negotiate and draft the document can be just as trying on a couple. No matter how difficult the journey, though, the conversations couples have in these instances are key, and the end result — a detailed agreement — will be a boon to the relationship. ●

Preparing Children And Grandchildren

The Dilemma: I need to prepare my children and grandchildren for the responsibility of wealth, but I'm afraid if they know too much, it will destroy any initiative to earn a living. How do I communicate this concern?

The founder is about to bequeath his fortune to young adult heirs who are ill-equipped to assume the mantle of great wealth if they have not been educated about money. How does the founder overcome his reluctance to hand over so much money — an amount so large that it will likely prevent the inheritors from attaining the same feelings of self-worth that he, the founder, enjoyed from his hard work and success?

The tension this situation presents is considerable. When a family goes from “rags to riches to rags,” it typically realizes too late the negligence that contributed mightily to its undoing — the lack of understanding of the inheriting generation's perspectives and their subsequent lack of preparation for handling wealth. Intermingled with these circumstances are issues of communication, financial education, self-esteem, and productivity.

Parents typically fear if they tell their children they are rich, those same children will grow up believing they are better than their peers and don't have to work for a liv-

ing. This results in confusion, which leads to either rampant spending or a timidity that causes heirs to fear even acknowledging the money.

Making It on Your Own

Haunted by terms like “idle rich” and “trust-fund babies,” inheritors grapple with the psychological ramifications of a fortune they received without having to lift a finger and, in many cases, without knowing how to fit the wealth into their lives. A paralyzing hesitancy grows out of feelings of inadequacy when it comes to managing money and the knowledge that they don't have to work for a living. As adults, the heirs feel inadequate and worthless compared to their peers who have forged a career. Lack of communication and preparation about wealth are at the root of the problem.

Coupled with these things is a suspicion that the founding generation doesn't trust the next one to be able to handle financial matters intelligently. Especially when given an income from a trust created by parents, inheritors are denied the opportunity to prove their worth by forging ahead with that particularly American ethos of creating an identity and being able to declare, “I made it.”

By not being required to earn a living, even at a career they might only be “trying on,” the heirs fail to gain the sense of control over their lives that comes with knowing they will always be able to support themselves. Setting a plan with a goal will give the heirs a sense of control and accomplishment. A trust income can help inheritors reject situations that don't appeal to them — this can have positive or negative consequences. The possibility of wealth means heirs can pursue careers they're passionate about without worrying about the salary. For those who are adrift, though, the drive to succeed can itself be a lifeline.

Talking the Talk

Parents have to have conversations about money. Signs of impending fiscal irresponsibility loom large for parents who haven't figured out how to broach the subject of the family fortune. Avoiding discussion of the “family secret” is common among the very groups that should be preparing their heirs. As strange as it seems to some, inheritors often need help becoming psychologically equipped to handle being born rich.

Timing a discussion about money depends on the children's maturity, but the earlier, the better. Once parents know how the child feels about having money, they can broaden the definition of wealth by discussing such

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attributes as kindness, good humor, health, and fulfillment not tied to money.

Parents should be prepared to answer all types of questions from their children, but should fend off specifics, such as telling young children the exact amount of the family's worth. Preemptive communication adds to the education of the kids, so they have insight into the hopes, dreams, and values of the family founders.

Walking the Walk

Parents set the best example for fiscal responsibility and offer guidance on assimilating wealth into their lives. In addition to deconstructing the myth of wealth through communication, families need to demonstrate their resolve to allow (or force) their children to be productive. The results are enormously gratifying when the heirs develop into self-supporting individuals with a healthy attitude toward wealth. ●

Fairness In Estate Planning

The Dilemma: I plan to be fair to my children, but if I leave them unequal amounts of money, am I setting up a future battleground?

The dilemma for wealthy families who intend to bequeath their fortune to their children is to do it in such a manner that each child is provided for, and that fiscal responsibility and trustworthiness are rewarded. It also means structuring the bequests to those without good judgment or financial skills in a way that gives them the opportunity and incentive to improve.

Seeking Equality

There are so many issues parents have to consider when creating an estate plan. Often, the older generation cares very much about equality, but even the smallest details about the estate can complicate the decisions disproportionately. The quality of the assets being handed down — even if they're just stocks and bonds — could vary and incite arguments about those different values. The situation is exacerbated when one factors in items of sentimental value — jewelry, real estate, vacation homes, and other heirlooms with personal as well as financial worth.

While the intention of the older generation might be to divide assets equally, there are often reasons to treat some children differently (age, mental or physical incapacity, level of responsibility, etc.). One of the best ways to avoid years of misunderstanding and resentment is for parents to talk with their children about their intentions

for distributing their assets. When the children understand the reasons behind an action, they are more likely to embrace it.

Making Intentions Clear

Aside from the desire to be fair, there are many reasons for parents to communicate to their heirs about the estate. If parents have developed a mission statement with their families, they will want to match their estate plan to that mission. If parents plan their estate around money, but don't discuss their values, the money will likely disappear in a way the parents didn't intend. By imparting values around money management, parents endow their children with a sense of stewardship over family assets.

Structuring Bequests

Trusts are favored ways to leave inheritances because they can save on certain inheritance taxes and enable parents to decide when their children will be mature enough to receive money and the amount of that inheritance. Other ways to protect beneficiaries include a college savings account for minor beneficiaries, to be used for higher education expenses.

For assets that have more sentimental than economic value, the best option is typically for parents and heirs to reach agreement while the parents are still alive about who receives what. If no decision can be made jointly in that manner (the children don't want to decide, or the parents are forced by some other circumstance to decide on their own), the parents may want to write a side letter to the will, explaining why they gave certain heirlooms to certain children and reinforcing that no heir was favored over any other. ●

Avoiding UGMA and UTMA

Parents considering leaving a college savings account might want to steer clear of Uniform Gift to Minor Accounts (UGMA) or Uniform Transfer to Minor Accounts (UTMA), because they usually pay out at the age of majority (usually 18 or 21), when the beneficiaries can spend the money any way they choose. Often these accounts are set up at the time of the birth of a child or grandchild and accumulate to a value far greater than what most account creators envision. The child merely has to show proof of age to take out the entire amount, at a time when the choice between paying for college tuition or buying a Maserati might not be as simple or logical a matter as one would think.

· Book 32 of 44 ·

Summary



The Only Way to Guarantee Your Fair Share of Stock Market Returns

The Little Book of Common Sense Investing

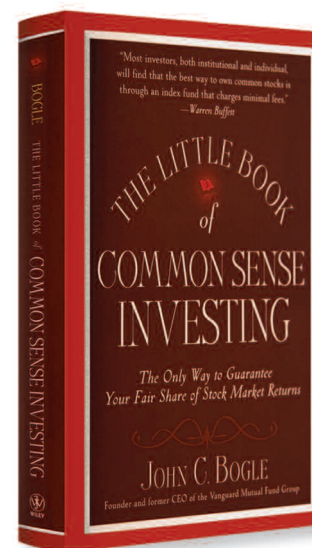
THE SUMMARY IN BRIEF

Investing is all about common sense. Owning a diversified portfolio of stocks and holding it for the long term is a winner's game. Trying to beat the stock market is theoretically a zero-sum game (for every winner there must be a loser), and after the substantial costs of investing are deducted, it becomes a loser's game. Common sense tells us, and history confirms, that the simplest and most efficient investment strategy is to buy and hold all of the nation's publicly held businesses at very low cost. Earning a fair share of whatever returns that our business enterprises are generous enough to provide is the definition of investment success.

Filled with in-depth insights and practical advice, this summary will show you how to incorporate this proven investment strategy into your portfolio. Not only does John C. Bogle show you what to do, he also shows you what not to do. He explains why the accepted market wisdom is designed to keep you in the dark. An understanding of the tyranny of compounding costs and the folly of speculation will lead investors to the only investment strategy that guarantees them their fair share of stock market returns. Successful investing is not easy; it requires discipline and patience. But it is simple, for it's all about common sense.

IN THIS SUMMARY, YOU WILL LEARN:

- Why business reality — dividend yields and earnings growth — is more important than market expectations.
- How to overcome investment costs, taxes and inflation.
- Why simplifying your investment strategy makes you a winner.
- How common sense investing trumps investment advisors.
- How compounding costs overwhelm compounding returns.



by John C. Bogle

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THE COMPLETE SUMMARY: THE LITTLE BOOK OF COMMON SENSE INVESTING

by John C. Bogle

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Don't Allow a Winner's Game to Become a Loser's Game

Successful investing is all about common sense. It is simple, but it is not easy. Simple arithmetic suggests, and history confirms, that the winning investment strategy is to own all of the nation's publicly held businesses at very low cost. By doing so, you are guaranteed to capture almost the entire return that they generate in dividends and earnings growth.

The best way to implement this strategy is indeed simple: Buy a fund that holds this market portfolio, and hold it forever. Such a fund is called an *index fund*. The index fund is simply a basket (portfolio) that holds many, many eggs (stocks) and is designed to mimic the overall performance of any financial market or market sector. Classic index funds basically represent the entire stock market basket, not just a few scattered eggs. These funds eliminate the risks of individual stocks, market sectors and manager selection. Only stock market risk remains.

The Investment Game

Over the past century, our corporations have earned a return on their capital of 9.5 percent per year. Compounded at that rate over a decade, each \$1 initially invested grows to \$2.48; over two decades, \$6.14; over three decades, \$15.22; over four decades, \$37.72; over five decades, \$93.48. The magic of compounding is little short of a miracle. Thanks to the growth, productivity, resourcefulness and innovation of our corporations, capitalism creates wealth, a *positive-sum game* for its owners.

As a group, investors are, by definition, average. Each extra return that one of us earns means that another of our fellow investors suffers a return shortfall of precisely the same dimension.

But the costs of playing the investment game both reduce the gains of the winners and increase the losses of the losers. So, who wins? The people in the middle (the brokers, investment bankers, money managers, marketers, accountants, lawyers, and operations departments of our financial system) — the croupiers in the market casino, if you will — are the only sure winners.

Academic studies suggest that if you are a typical investor in individual stocks, your returns have probably lagged the market by about 2.5 percentage points per year, largely because of the costs they incur. Applying that figure to the annual return of 12 percent earned over the past 25 years by the Standard & Poor's 500 Stock Index, your return has been less than 10 percent. ●

A Parable: The Gotrocks Family

Perhaps this homely parable — a version of a story told by Warren Buffett, chairman of Berkshire Hathaway Inc., in the firm's 2005 Annual Report — will illustrate the foolishness and counter productivity of our vast and complex financial market system.

Once upon a time . . .

A wealthy family named the Gotrocks had grown over the generations to include thousands of brothers, sisters, aunts, uncles and cousins, and owned 100 percent of every stock in the United States. Each year they reaped the rewards of investing: all the earnings growth that those thousands of corporations generated and all the dividends that they distributed. Each family member grew wealthier at the same pace, and all was harmonious. Their investment had compounded over decades, creating enormous wealth, because the Gotrocks family was playing a winner's game.



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Summary: THE LITTLE BOOK OF COMMON SENSE INVESTING

After a while, a few fast-talking Helpers arrive on the scene, and they persuade some “smart” Gotrocks cousins that they can earn a larger share than the other relatives. These Helpers convince the cousins to sell some of their shares to other family members and to buy other shares from them in return. The Helpers handle the transactions and they receive commissions for their services.

To the Gotrocks’ surprise, the family wealth now grows at a slower pace. This is because some of the return is now consumed by the Helpers. To make matters worse, while the family had always paid taxes on their dividends, some of the members are now also paying taxes on the capital gains they realize from their stock swapping, further diminishing the family’s total wealth.

The smart cousins quickly realize that their foray into stock picking has been a failure and conclude that they need professional assistance. So they hire stock-picking experts — more Helpers! These money managers charge a fee for their services and now feel compelled to earn their keep by trading the family’s stocks at a feverish pace, not only increasing the brokerage commissions paid to the first set of Helpers, but running up the tax bill as well. The family’s share of the dividend and earnings pie is further diminished.

Undeterred by their previous two failures, the smart cousins decide to hire still more Helpers. They retain the best financial consultants and financial planners they can find who agree to help them pick the right stocks — for a fee. Once again the family’s share of the pie tumbles.

Alarmed at last, the family sits down together and takes stock of the events that have transpired since some of them began trying to outsmart the others. “How is it,” they ask, “that our original 100 percent share has dwindled to just 60 percent?” The wisest family member, an old uncle responds: “All that money you’ve paid to those Helpers and all those unnecessary extra taxes you’re paying come directly out of our family’s total earnings and dividends. Go back to square one and do so immediately. Get rid of all your brokers, money managers and consultants. Then our family will again reap 100 percent.”

They follow the old uncle’s advice, returning to their original passive but productive strategy, holding all the stocks of corporate America and standing pat.

That is exactly what an index fund does.

Adding a fourth law to Sir Isaac Newton’s three laws of motion, Warren Buffett puts the moral of the parable this way: *For investors as a whole, returns decrease as motion increases.*

Additionally, the parable reflects the profound conflict of interest between those who work in the investment business and those who invest in stocks and bonds. The way to wealth for those in the business is to persuade their clients, “*Don’t just stand there. Do something.*” But the way to wealth for clients in the aggregate is to follow the opposite maxim: “*Don’t do something. Just stand there.*” ●

Rational Exuberance

In the long run, stock market returns are determined almost entirely by the economics of investing — the earnings and dividends produced by American corporations. Indeed, the long-term investment return of 9.5 percent (4.5 percent from dividends and 5 percent from earnings growth) nearly matches the market’s return of 9.6 percent. The 0.1 percent difference represents the market’s speculative return, or the changing price investors are willing to pay for a dollar of earnings (or the P/E ratio). While investor emotions, represented by the speculative return, can dominate over the short term, it is the economics of investing that hold sway in the long term.

But in our foolish focus on the short-term stock market distractions of the moment, we often overlook this long history. We ignore the fact that when returns on stocks depart materially from the long-term norm, it is rarely because of the *economics* of investing. Rather, the reason that annual stock returns are so volatile is largely because of the *emotions* of investing.

Reality Rules

While the prices we pay for stocks often lose touch with the reality of corporate values, in the long run, reality rules. So, while investors seem to intuitively accept that the past is inevitably prologue to the future, any past stock market returns that have included a high speculative stock return component are a deeply flawed guide to what lies ahead.

It is economics that controls long-term equity returns; emotions, so dominant in the short term, dissolve. Forecasting the long-term *economics* of investing carries remarkably high odds of success, while accurately forecasting swings in investor *emotions* is not possible.

The stock market is a giant distraction that causes investors to focus on the transitory and volatile emotions of investing rather than on what is really important — the gradual accumulation of the returns earned by corporate business. ●

Cast Your Lot with Business

By far the simplest way to own all of U.S. business is to hold the total stock market portfolio. For most of the past 80 years, the accepted stock market portfolio was represented by the Standard & Poor's 500 Index (the S&P 500), which was created in 1926 and now lists 500 stocks. It is essentially composed of the 500 largest U.S. corporations, weighted by their market capitalizations. In recent years, these 500 stocks have represented about 80 percent of the market value of all U.S. stocks.

The beauty of such a *cap-weighted* index is that it automatically adjusts to changing stock prices and never has to buy and sell stocks for that reason. The S&P 500 remains a valid standard against which to compare the returns earned by the professional managers of pension funds and mutual funds.

In 1970, an even more comprehensive measure of the U.S. stock market was developed. Originally called the Wilshire 5000, it is now named the Dow Jones Wilshire Total Stock Market Index. It includes some 4,971 stocks, including the 500 stocks in the S&P 500. However, because its component stocks also are weighted by their market capitalization, those remaining 4,471 stocks account for only about 20 percent of its value. Nonetheless, this broadest of all U.S. stock indexes is the best measure of the aggregate value of stocks, and therefore a superb measure of the returns earned in U.S. stocks by all investors as a group.

The two indexes have a similar composition so it is hardly surprising that the two indexes have earned returns that are in lockstep with one another.

Investors should remember the relentless rules of humble arithmetic — gross returns of the market, minus costs, equal the net returns earned by investors. Common sense, then, tells us the obvious; while owning the stock market over the long term is a winner's game, beating the stock market is a loser's game.

Birth of the Index Mutual Fund

The world's first index mutual fund — now known as the Vanguard 500 Index Fund — started in 1976. At a dinner on September 20, 2006, celebrating the 30th anniversary of the fund's initial public offering, the counsel for the fund's underwriters reported that he had purchased 1,000 shares at the original offering price of \$15 per share — a \$15,000 investment. He proudly announced that the value of his holding that evening (including shares acquired through reinvesting the fund's dividends and distributions over the years) was \$461,771.

This cumulative long-term winning record confirms that owning American business through a broadly diversified index fund is not only logical but incredibly productive. Sir William of Occam expressed it well in his famous precept: *when there are multiple solutions to a problem, choose the simplest one.* Instead of joining the crowd of investors who dabble in complex machinations to pick stocks and try to outguess the stock market, choose the simplest of all solutions — buy and hold the market portfolio. ●

How Most Investors Turn a Winner's Game into a Loser's Game

Beating the market before costs is a zero-sum game; beating the market after costs is a loser's game. For individual investors holding stocks directly, trading costs average about 1.5 percent per year. The cost is lower (about 1 percent) for those who trade infrequently and much higher for investors who trade frequently (for example, 3 percent for investors who turn their portfolios over at a rate above 200 percent per year).

In equity mutual funds, management fees and operating expenses — combined, called the *expense ratio* — average about 1.5 percent per year of the fund assets. Then add, say, another 0.5 percent in sales charges, assuming that a 5 percent initial sales charge is spread over a 10-year holding period. If the shares are held for five years, the cost would be twice that figure — 1 percent per year.

But then also add a giant additional cost, all the more pernicious by being invisible, the hidden cost of portfolio turnover, estimated at a full 1 percent per year. The average fund turns its portfolio over at a rate of about 100 percent per year, meaning that a \$5 billion fund buys \$5 billion worth of stocks each year and sells another \$5 billion. At that rate, brokerage commissions, bid-ask spreads and market impact costs add a major layer of additional costs. Result: the “all-in” cost of equity fund ownership can come to as much as 3 percent to 3.5 percent per year. So yes, *costs matter*.

Obvious Reality

It is hardly in the interest of our financial intermediaries to encourage their investors/clients to recognize the obvious reality of the detrimental impact of these costs. Investors pay far too little attention to the costs of investing. But they are truly confiscatory over an investment lifetime. Over 50 years, a \$10,000 investment earning 8 percent annually would grow to \$469,000. Annual costs

Summary: THE LITTLE BOOK OF COMMON SENSE INVESTING

of 2.5 percent would reduce that return to 5.5 percent, a rate which would grow that initial \$10,000 investment to just \$145,400 — a shocking loss of 69 percent of the market's total return.

Where returns are concerned, time is your friend. But where costs are concerned, time is your enemy.

The humble arithmetic of investing — the logical, inevitable and unyielding penalty assessed by investment costs and rising living costs — has devastated the returns earned by mutual fund investors. Unless the fund industry changes and improves the net return it delivers to fund shareholders, it will falter and finally fail. ●

The Grand Illusion

The traditional *time-weighted* return reported by the funds — the change in asset value of each fund share, adjusted to reflect the reinvestment of all income dividends and capital gains distribution — does not tell us what return was earned by the average investor. And that return turns out to be far lower.

When we compare traditionally calculated fund returns with the returns actually earned by their investors over the past quarter century, we find that while the stock market index fund was providing an annual return of 12.3 percent and the average equity *fund* was earning an annual return of 10.0 percent, the average fund *investor* was earning only 7.3 percent. Thus, instead of earning \$17 on each dollar invested in the market, the average investor instead earned just \$4.80.

What explains this shocking lag? Simply put, counter-productive market timing and fund selection, as investors, following their emotions, poured their money into the market not only at the wrong time, but into the wrong funds. In both failures, investors simply failed to practice what common sense would have told them. ●

Taxes are Costs, Too

There is yet another cost — too often ignored — that slashes even further the net returns that investors actually receive: federal, state and local income taxes. The fact is that most managed mutual funds are astonishingly tax-inefficient, a result of the short-term focus of their portfolio managers.

A paradox: While the index fund is remarkably *tax-efficient* in managing capital gains, it turns out to be relatively *tax-inefficient* in distributing dividend income. Why? Because its rock-bottom costs mean that nearly all the dividends paid on the stocks held by the low-cost index fund actually flow directly into the hands of the index

fund's shareholders. With the high expense ratios incurred by managed funds, however, only a tiny portion of the dividends that the funds receive actually find their way into the hands of the fund's shareholders.

Here is the unsurprising and relentless arithmetic: the annual gross dividend yield earned by the typical active equity fund *before deducting fund expenses* is about the same as the dividend yield of the low-cost index fund — 1.8 percent in late-2006. But after deducting the 1.5 percent of expenses borne by the typical active fund, its net dividend yield drops to just 0.3 percent (!) for its owners. Fund operating costs and fees confiscate fully 80 percent of its dividend income.

The wise investor will seek the dividend “tax-inefficiency” of the index fund dividend rather than the “tax-efficiency” of most actively managed funds engendered by their confiscatory operating costs. ●

When the Good Times No Longer Roll

Common sense tells us that we're facing subdued returns in the stock market over the coming decade. Why? First, because today's dividend yield on stocks is not the 4.5 percent historical rate, but slightly below 2 percent. Combined with an optimistic projection of 6 percent earnings growth, the projected 8 percent investment return would be slightly below the historical norm. Second, it seems more likely that the current P/E of 18 might ease down a bit to, say, 16 (15 times is the historical norm) rather than rise to 20 or higher. Such a decline would reduce the investment return by about 1 percentage point, to an annual rate of 7 percent.

The fact is that lower returns harshly magnify the relentless arithmetic of excessive mutual fund costs, even ignoring all those unnecessary taxes. While costs of 2.5 percentage points would consume “only” 16 percent of a 15 percent return and “only” 25 percent of a 10 percent return, such costs would consume nearly 40 percent of a 7 percent *nominal* return and nearly 60 percent of the 4.5 percent *real* return on stocks that rational expectations suggest.

While many investors will attempt to find managers and/or advisers they believe will improve upon this projected performance, history demonstrates, clearly, that their efforts are overwhelmingly likely to fail. Indeed, further reducing these humble returns by the costs and taxes imposed by the typical equity fund produces a projected annual return of 1.4 percent for the average equity fund, a number that is unacceptable. ●

Selecting Past Winners

Selecting winning funds in advance is more difficult than it looks. Sure there are always some winners that survive over the years. But as easy as it is to identify past winners, there is little evidence that such performance will persist in the future.

Of the original 355 equity funds in 1970, 223 have gone out of business, mostly the poor performers. Another 60 remained, yet significantly underperformed the S&P 500 by more than 1 percentage point per year. Together, 283 funds — nearly 80 percent of the funds among those original 355 — failed to distinguish themselves. Another 48 funds provided returns within one percentage point, plus or minus, of the return of the S&P 500 — market matchers, as it were.

That leaves just 24 mutual funds — *only one out of every 14* — that outpaced the market by more than one percentage point per year. Just nine of those outpaced the S&P 500 by 2 percentage points or more during the period, and six of those achieved their superiority many years ago, often when they were of small size. Three peaked no more recently than 1993, so just the remaining three funds out of the 355 that started the race in 1970 have survived and mounted a record of sustained excellence: Davis New York Venture, Fidelity Contrafund, and Franklin Mutual Shares. But before you rush out to invest in these three funds, think about the next 35 years and the odds that they will continue to outperform. Funds with long-serving portfolio managers and records of consistent excellence are clearly the exception rather than the rule in the mutual fund industry.

In selecting mutual funds, most fund investors seem to rely not on sustained performance over the long term, but on exciting performance over the short term. But history demonstrates that shorter-term performance is an even more perilous guide than long-term performance. The top ten performing funds from 1997–1999, for instance, earned a cumulative return averaging 279 percent — stunning! But during the three years that followed, their average cumulative return plummeted to -70 percent. ●

Seeking Advice to Select Funds?

The overwhelming majority of investors rely on brokers or advisers for help in penetrating the dense fog of complexity that, for better or worse, permeates our financial system. If you consider the selection of an adviser, make sure you are paying a fair fee (which results

in a deduction from whatever rate of return your fund portfolio earns). Be sure to balance the worth of the peripheral services that advisers provide against the reduction in your returns that those fees are likely to represent over time. Finally, look with particular favor on advisers who recommend stock and bond index funds in their model portfolios. ●

Focus on the Lowest-Cost Funds

How can successful fund selection prove so difficult? Because of something that, deep down, our common sense tells us: *Performance comes and goes, but costs go on forever.*

If investors could rely on only a single factor to select future superior performers and to avoid future inferior performers, it would be fund costs. The record could hardly be clearer: *the more the managers and brokers take, the less the investors make.*

If the road to investment success is filled with dangerous turns and giant potholes, never forget that simple arithmetic can enable you to moderate those turns and avoid those potholes. So do your best to diversify to the nth degree; minimize your investment expenses; and focus your emotions where they cannot wreak the kind of havoc that most other people experience in their investment programs. Rely on your own common sense. Emphasize all-stock-market index funds. Carefully consider your risk tolerance and the portion of your investments you allocate to equities. Then stay the course. ●

Bond Funds and Money Market Funds

The relentless rules of humble arithmetic also apply — arguably even more forcefully — to bond funds and money market funds.

While a seemingly infinite number of factors influence the stock market and each individual stock that is traded there, a single factor influences the bond market and the money market (and for that matter, each individual fixed-income security) far more than any other: the prevailing level of interest rates. Managers of fixed-income funds can't do much, if anything, to influence rates. Virtually 100 percent of the return on any bond fund or money market fund is accounted for by the net interest income it generates for its shareholders. The only way for a manager to add an increment to that return is to make interest rate bets — for example, by selling bonds when he expects rates to go up (and prices down), and then buying bonds when the reverse

is expected to happen. Even the best bond and money market managers can add only a few fractions of one percent per year to your long-term returns, albeit only by risking a comparable shortfall.

Investors are far more focused on equity funds and the stock market than on fixed-income funds. Nonetheless, smart investors will save themselves lots of money — and substantially improve their returns — if they apply the same principles of broad diversification, low-cost, no-load, minimal turnover and long-term investing when they select fixed income funds. These are the very commonsense characteristics that enable index funds to guarantee your fair share of the returns in the bond and money markets, even as they do in all financial markets. ●

Index Funds That Promise to Beat the Market

The only way to beat the market portfolio is to depart from the market portfolio. And this is what active managers strive to do, individually. But collectively, they can't succeed, for their trading merely shifts ownership from one holder to another. And in the aggregate, of course, they all earn the market's return, minus their costs.

There are now financial entrepreneurs who believe they can create indexes that will beat the market. This new breed of indexers — not, in fact, indexers, but active strategists — focuses on weighting portfolios by so-called fundamental factors. Rather than weighting by market cap, they use a combination of factors such as corporate revenues, cash flows, profits, or dividends. And — no surprise — back-testing demonstrates that such strategies would have improved returns in the past. But even if those margins persist in the future — which is highly unlikely — these hypothetical returns would be significantly eroded, if not entirely eliminated, by costs and taxes.

When active managers of equity funds claim to have a way of uncovering extra value in our highly efficient U.S. stock market, investors will look at their past record, consider the manager's strategies, and invest or not. These new index managers are in fact active managers. Be skeptical.

Investors should not be tempted by the siren song of paradigms that promise the accumulation of wealth that will be far beyond the rewards of the classic index fund. ●

The Exchange Traded Fund

Simply put, the exchange traded fund (ETF) is a fund designed to facilitate trading in its shares, dressed in the guise of the traditional index fund. The growth of ETFs has approached a stampede, not only in number but also in diversity, as there are now ETFs that track virtually every possible market segment and style.

All-stock-market ETFs are the only instance in which an ETF can replicate, and possibly even improve on the original classic index fund. *But only when they are bought and held for the long term.* Their annual expense ratios are usually — but not always — slightly lower than their mutual fund counterparts, although commissions on purchases erode any advantage, and may even overwhelm it. While their tax efficiency should be better, actual practice has failed to confirm theory, and investors who trade them are subject to their own taxes.

Too many ETFs may prove, if not suicidal to their owners in financial terms, at least wealth depleting. ●

The Relentless Rules of Humble Arithmetic

Historical returns are of no value unless we can explain the source of those returns. The two basic sources of the superior returns achieved by the index fund are: (1) the broadest possible diversification, eliminating individual stock risk, style risk and manager risk, with only market risk remaining; and (2) the tiniest possible costs and minimal taxes. Together, they enable the index fund to provide the gross return earned in the stock market minus a scintilla of cost.

What Should I Do Now?

The vast majority of American families will be well served by owning their equity holdings in an all-U.S. stock-market index portfolio and holding their bonds in an all-U.S. bond-market index portfolio. (Investors in high tax brackets, however, would hold a very low-cost, quasi-index portfolio of high-grade intermediate-term municipal bonds.) The rationale for a 100-percent-index-fund portfolio remains as solid as a rock. It's all about common sense.

It is likely that very few investors will follow that approach — the essence of simplicity — for their entire investment portfolio. Investors seem all too willing to opt for costly active funds and trade them to excess. Why?

Summary: THE LITTLE BOOK OF COMMON SENSE INVESTING

We are sold funds more often than we buy them. We have far too much self confidence. We crave excitement. We succumb to the distraction that is the stock market. We fail to understand the arithmetic of investing and the arithmetic of mutual funds.

Funny Money

There are no surefire solutions for investment success — wealth without risk, if you will. It's just not a realistic expectation. Nonetheless, building an investment portfolio can be exciting, and trying out modern remedies for age-old problems lets you exercise your animal spirits. If you crave excitement, enjoy the fun! *But not with one penny more than 5 percent of your investment assets.* This can be your Funny Money account.

Test two or three aggressive investment strategies. You're likely to learn some valuable lessons, and it probably won't hurt you too much in the short term.

Be sure to regularly measure your returns and compare them with the returns you've earned in your Serious Money Account.

Serious Money

At least 95 percent of your investments should be in your Serious Money account. That core of your program should consist of at least 50 percent in classic index funds, up to 100 percent.

Investment Strategies

While the pristine and classic all-U.S. stock market and all-U.S. bond market approach is encouraged, there are perfectly reasonable alternative strategies for supplementing the index funds in your Serious Money portfolio. These include:

- **An international flavor:** Hold a low-cost total international index fund that tracks the returns of all non-U.S. corporations. A modest holding in a low-cost emerging market index fund is also a reasonable approach, but be sure you understand the risks.

- **Slice and dice:** Hold the all-market index fund as the core and add a value index fund and a small-cap index fund as satellites.

- **Bond strategy:** Combine a mix of index funds linked to short-term, intermediate-term and long-term bonds in varying amounts.

- **Inflation protection:** Inflation-linked bonds provide excellent protection against the long-term erosion of the purchasing power of the dollar, particularly in tax-deferred accounts.

- **Asset allocation:** Hold a bond position equal to your age — 40 percent if you are 40, 70 percent when you are 70, and so on — or maybe even your age minus 10 percent.

- **Target date funds:** Investors can begin with an allocation appropriate to their age, which inches gradually toward a more conservative allocation as they approach the retirement age they have targeted.

Common Sense Realities

As you seek investment success, realize that it's never given for us to know what returns stocks and bonds will deliver in the years ahead, nor can we know the future returns that might be achieved by alternatives to the index portfolio. But take heart. For all the inevitable uncertainty amidst the eternally dense fog surrounding the world of investing, there remains much that we do know. Consider these common sense realities:

- We know that we must start to invest at the earliest possible moment, and continue to put money away regularly from then on.

- We know that investing entails risk. But we also know that not investing dooms us to financial failure.

- We know the sources of returns in the stock and bond markets.

- We know that the risk of selecting specific securities, as well as the risk of selecting both managers and investment styles, can be eliminated by the total diversification offered by the classic index fund. Only market risk remains.

- We know that costs matter, overpoweringly in the long run, and we know that we must minimize them. (We also know that taxes matter, and that they, too, must be minimized.)

- We know that neither beating the market nor successfully timing the market can be generalized without self-contradiction. *What may work for the few cannot work for the many.*

- We know that alternative asset classes such as hedge funds aren't really alternative, but simply pools of capital that invest — or overinvest or disinvest — in the very stocks and bonds that comprise the portfolio of the typical investor.

- We know what we *don't* know. We can never be certain how our world will look tomorrow, and we know far less about how it will look a decade hence. But with intelligent asset allocation and sensible investment selections, you will be prepared for the inevitable bumps along the road and should glide right through them. ●

· Book 33 of 44 ·

Summary



A Guide to Beating the Market for All Ages

The Little Book That Beats The Market

THE SUMMARY IN BRIEF

You can achieve investment returns that beat the pants off even the best investment professionals and the top academics. In fact, you can learn how it's possible to more than double the annual returns of the stock market averages.

But there's more. You can do it all by yourself. You can do it with low risk. You can do it without making any predictions, and you can do it by following, step by step, a "magic formula" that uses only common sense and two simple concepts. Best of all, once convinced that it really works, you can choose to do it for the rest of your life.

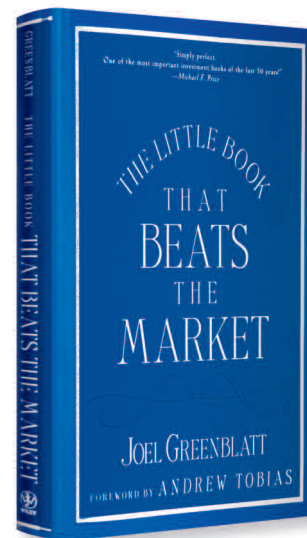
The formula has been tested over hundreds of different periods and thousands of stock picks, and has been proven extremely profitable for those who are willing to "stick with it."

While the concepts covered in this summary may seem simple — perhaps too simple for sophisticated investors — each step along the way is there for a reason. Stay with it, and the payoff for both beginning and experienced investors will be huge.

It's never too early or too late to start investing, and by following the simple steps and the Magic Formula that are clearly outlined and explained, you can achieve extraordinary long-term investment results with a very low level of risk. With this summary as your guide, you'll know exactly where to go and what to do — and it won't even take much time, just a little effort every few months.

IN THIS SUMMARY, YOU WILL LEARN:

- What options you have for saving and investing.
- What it means to invest in a company and buy stocks.
- How the stock market works.
- What the "magic formula" is and how you can use it to grow your money.
- How to find good companies at bargain prices.
- How you can beat the market all by yourself.



By Joel Greenblatt

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THE COMPLETE SUMMARY: THE LITTLE BOOK THAT BEATS THE MARKET

by Joel Greenblatt

The author: Joel Greenblatt is the founder and a managing partner of Gotham Capital, a private investment partnership that has achieved 40 percent annualized returns since its inception in 1985. He is a professor on the adjunct faculty of Columbia Business School, the former chairman of the board of a Fortune 500 company, the co-founder of ValueInvestorsClub.com, and the author of *You Can Be a Stock Market Genius*. Greenblatt holds a BS and an MBA from the Wharton School.

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Part One: Saving Money

It takes a great amount of discipline to save any money. After all, no matter how much money you earn or receive from others, it's simply much easier and more immediately rewarding to find something to spend it on.

When author Joel Greenblatt was young, he decided that all of his money should go to Johnson Smith. Of course, he'd love to tell you that Johnson Smith was an orphan who just needed a little help. He'd love to tell you that the money given to Johnson Smith helped change his life. He'd love to tell you that, but it wouldn't be completely accurate. You see, Johnson Smith was a company that sold whoopee cushions, itching powder and imitation dog vomit through the mail.

Greenblatt didn't completely throw away all his money. He writes that he did buy some educational stuff, too. Once, the guys at Johnson Smith were able to sell him a weather balloon that was 10 feet tall and 30 feet around. He and his brother finally figured out how to blow it up by somehow reversing the airflow on the vacuum cleaner, but they ran into a big problem. The 10-foot balloon was quite a bit larger than their front door. Using a complicated formula that not even Einstein could fully comprehend, they decided that if they turned their backs and pushed really hard. The giant balloon could be squeezed out without bursting.

And it worked, except they forgot one thing. It seems that the air outside was colder than the air inside their house. That meant that they had filled their balloon with warm air. And since hot air rises, the balloon started to float away. The two of them were left

chasing a giant balloon down the street for about half a mile before it finally popped on a tree.

Investment Strategies

Luckily, Greenblatt learned a valuable lesson from the whole experience. Although he doesn't exactly remember what that was, he writes that he is pretty sure it had something to do with the importance of saving money for things that you might want or need in the future rather than wasting money buying the giant weather balloons that you get to chase down the block for all of three or four minutes.

Let's assume that we can all agree that it is important to save money for the future. Let's also assume that you have been able to resist the many temptations of the Johnson Smith people and the thousands of other places calling out for your money; that you have been able to provide for all of the necessities of life, including food, clothing and shelter; and that by being careful about how much you spend, you have somehow been able to put aside at least a small amount of money. Your challenge is to put that money — let's say \$1,000 — someplace where it can grow to be even more money.

Sure, you can just put it under your mattress or in your piggy bank, but when you come to get it, you'll still be left with the same \$1,000 you put there in the first place. It won't grow at all. In fact, if the prices of the things you were going to buy with that money go up during the time your money was just sitting there, your money will actually be worth less than it was worth the day you put it away. In short, the mattress plan kind of stinks.

Plan B has got to be better. And it is. Just take that \$1,000 over to the bank. Not only will the bank agree to



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Rebecca S. Clement, Publisher; Sarah T. Dayton, Managing Editor; Joanne Merenda, Graphic Designer; Tom Moore, Contributing Editor

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hold your money, they'll pay you for the privilege. Each year, you'll collect interest from the bank and, in most cases, the longer you agree to let them hold your money, the higher the interest rate you'll get. If you agree to keep your \$1,000 with the bank for five years, you might collect something like 5 percent in interest payments per year. After five years, your \$1,000 will grow into \$1,276. Not bad and certainly better than the mattress plan.

Which brings us to Plan C. This plan is known as "who needs the bank?" There's an easy way to just skip the bank altogether and lend to businesses or to a group of individuals yourself. Often, businesses borrow money directly by selling bonds. If you purchase a \$1,000 bond from a large company, for example, that company might agree to pay you 8 percent each year and pay back your original \$1,000 after 10 years.

Investment Risks

There's one little problem. If you buy a bond from one of these companies and something goes wrong with the business, you may never get your interest or your money back. That's why riskier companies usually have to pay higher interest rates than more solid, established ones. That's why a company's bonds have to pay more than the bank. People need to make more money on their bond to make up for the risk that they may not receive the promised interest rate or their original money back.

If you're not comfortable taking any risk of losing your \$1,000, the U.S. government sells bonds too. For our purposes, the bond we'll be looking at is the one that matures after 10 years and compare that with our other long-term investment choices.

So if the annual interest rate on the 10-year government bond is 6 percent, that essentially means that people who are willing to lend their money out for 10 years, but are unwilling to take any risk of losing their original investment, can still expect to receive 6 percent each year on their money.

That means that if anyone asks you to loan them money or to invest with them over the long term, they better expect to pay you more than 6 percent a year. Why? Because you can get 6 percent a year without taking any risk.

The big picture is that we want to make sure we earn a lot more from our other investments than we could earn without taking any risk. Obviously, if long-term U.S. government bond rates rose to 7

percent or higher, we would use 7 percent or that higher number. ●

Part Two: Investing in a Company

Okay, what else can you do with your money? Let's face it: Putting money in the bank or lending it to the government is really boring. How about investing in a business?

A Case Study — Jason's Gum Shops

Let's say Jason wants a hefty \$6 million for half ownership of his business. Of course, 6 million bucks is more than most of us can afford, but, luckily, Jason isn't looking to sell half ownership of his business all to one person. In fact, he has decided to divide ownership of his business into a million equal pieces, or shares.

Jason's plan is to keep 500,000 shares for himself and sell the other 500,000 shares for \$12 apiece or \$6 million total. If you were to buy, for example, 10,000 shares costing \$120,000 you would then own 1 percent of Jason's Gum Shops (10,000 shares divided by the 1-million-share total). That doesn't mean that you would own the spearmint gum department or a small piece of one of Jason's stores. It means that you would be entitled to 1 percent of the future earnings of the entire business.

Now, of course, all you would have to do is figure out whether paying \$120,000 for 1 percent of Jason's future gum profits is a good deal. It seems that last year Jason sold a total of \$10 million worth of gum from the 10 stores in his chain. Unfortunately, \$10 million isn't how much profit Jason made. Obviously, Jason's stores ran up a few expenses along the way. There was the cost of the gum that Jason sold — that totaled \$6 million. That left him with \$4 million in profits. He also had to pay rent and those pesky employees. There were electricity and heating costs, trash removal and accounting and all kinds of administrative costs and that stuff adds up. In this case, another \$2 million, bringing Jason's business down to \$2 million in profits.

Jason's business had to pay 40 percent taxes of that \$2 million — or \$800,000 — leaving him with a net profit of \$1.2 million.

Actually, Jason provided us with all that information about last year's income in a very neat table, known as an income statement.

That means if the whole business earned \$1,200,000 each share earned one-millionth of that amount, or

Summary: THE LITTLE BOOK THAT BEATS THE MARKET

\$1.20 in earnings. If we invest \$12 for a piece of Jason's business and it earns us \$1.20 in the first year, our return on our investment would be \$1.20 divided by \$12 or 10 percent. The earnings from your share of the profits must give you more money than you would receive by placing that same amount of money in a risk-free, 10-year U.S. government bond.

But it's not quite that simple. First, the \$1.20 per share is what Jason's Gum Shops earned last year. Second, we have to come up with our estimate for how much he will earn next year and how confident we are in our prediction. The third little detail we haven't yet considered is that next year is only one year. Even if Jason's Gum Shops earns \$1.20 next year (or a lot more or a lot less), what about all the years after that? ●

Part Three: The Stock Market

Stock prices move around wildly over very short periods of time. Looking at the price for shares over a two- to three-year period would give us an even wider range.

Each day the newspaper lists the names of thousands of companies and the price at which people have been buying and selling an ownership share in each. The *trading* back and forth of these ownership shares takes place in a number of locations and over computer networks. These ownership shares are referred to as *shares of stock*, and collectively, this buying and selling activity is referred to as the *stock market*.

Interpreting Market Fluctuations

Why do share prices move around so much every year when it seems clear that the values of the underlying businesses do not? Who knows and who cares? They do!

Suppose you figured that a business was worth between \$10 and \$12 per share, and at varying times during the year, its shares could be purchased for between \$6 and \$11. If you were confident about your estimate of what the business was worth, then deciding whether to buy shares when they were trading near \$11 might be a difficult decision. But when shares in that same company during that same year were available at close to \$6, your decision might well become much easier.

You are never required to act. You alone can choose to act only when the price offered by Mr. Market appears very low (when you might decide to buy some shares) or extremely high (when you might consider selling any shares you own).

Discount Buying

It is a good idea to buy shares of a company at a big discount to your estimated value of those shares. Buying shares at a large discount to value will provide you with a large margin of safety and lead to safe and consistently profitable investments.

But there's still a problem here. How are you supposed to know what a business is worth? Second, if you could figure out the value of a business, how would you know you were right? Third, aren't there tons of smart, hard-working people trying to figure out all this stuff too?

Paying a bargain price when you purchase a share in a business is a good thing. One way to do this is to purchase a business that earns more relative to the price you are paying rather than less. In other words, a higher earnings yield (calculated by dividing the earnings per share for the year by the share price) is better than a lower one.

Return on Capital

Buying a share of a *good* business is better than buying a share of a *bad* business. One way to do this is to purchase a business that can invest its own money at high rates of return rather than purchasing a business that can only invest at lower ones. In other words, businesses that earn a high return on capital are better than businesses that earn a low return on capital. ●

Part Four: The Magic Formula

What do you think would happen if we simply decided to buy shares in companies that had *both* a high earnings yield and a high return on capital? In other words, what would happen if we decided to only buy shares in good businesses (ones with high returns on capital) but only when they were available at bargain prices (priced to give us a high earnings yield)?

We would make a lot of money!

Measuring the Results

Does it make sense that something this simple and obvious would actually work in the real world? Well, to answer that question, a logical first step might be to go back and see how a disciplined strategy of buying *good businesses at bargain prices* would have worked in the past.

Over the last 17 years, owning a portfolio of approximately 30 stocks that had the best combination of a high return on capital and a high earnings yield would have

Summary: THE LITTLE BOOK THAT BEATS THE MARKET

returned approximately 30.8 percent per year. Investing at that rate for 17 years, \$11,000 would have turned into well over \$1 million.

During those same 17 years, the overall market averaged a return of about 12.3 percent per year. At that rate, \$11,000 would still have turned into an impressive \$79,000. While that certainly is a lot, \$1 million is more.

Raising the Bar

Let's see what happens when we raise the bar a little bit. Let's look at just the largest 2,500 companies. Over the last 17 years (ending in December 2004), the magic formula worked remarkably well for this group. Owning a portfolio of 30 stocks chosen by the magic formula would have achieved an annual return of 23.7 percent. During that same period the market's average return for this group was 12.4 percent per year. In other words, the magic formula practically doubled the market's average annual return.

When we narrowed the group to just the largest 1,000 stocks, it appears that even the largest investors can practically double the market's compounded annual return simply by following the magic formula.

Throughout the 17 years of our study, we held a portfolio of roughly 30 stocks. Each stock was held for a period of one year. In all, over 1,500 different stock picks were made for each of the tests. When we combine all of our tests, they are the results of over 4,500 separate selections.

Starting with the largest 2,500 companies, what if we ranked them again using the magic formula from 1 to 2,500, from best to worst? That means the companies that appeared to be in good businesses and available at bargain prices would be ranked closer to number 1, while the companies losing lots of money that were offered at expensive prices would be ranked closer to 2,500.

We then divided those 2,500 companies into 10 equal groups based on their rankings, with group 1 being the 250 companies that the magic formula viewed as good companies at bargain prices and group 10 being the 250 stocks that the magic formula ranked as being poor companies at expensive prices.

What would happen if we did this every month for 17 years? What if we held each of those stock portfolios (each containing roughly 250 stocks) for one year and calculated the returns? The magic formula appears to work in order. The best-ranked stocks perform the best and as the ranking drops, so do the returns (see table).

Annualized Return (1988-2004)

Group 1	17.9%
Group 2	15.6%
Group 3	14.8%
Group 4	14.2%
Group 5	14.1%
Group 6	12.7%
Group 7	11.3%
Group 8	10.1%
Group 9	5.2%
Group 10	2.5%

A Magic Formula Warning

Unfortunately, looking at the statistics for only our very successful 17-year test period, it turns out there's actually plenty to worry about. The magic formula fared poorly relative to the market averages in five out of every 12 months tested. For full-year periods, the formula failed to beat the market averages once every four years. For one out of every six periods tested, the magic formula did poorly for more than two years in a row. There were even some periods when the formula did worse than the overall market for three years in a row.

The unpredictability of Mr. Market's moods and the pressures of competing with other money managers can make it really hard to stick with a strategy that hasn't worked for years.

So what's the point? The point is that if the magic formula worked all the time, everyone would probably use it. If everyone used it, it would probably stop working. So many people would be buying the shares of the bargain priced stocks selected by the magic formula that the prices of those shares would be pushed higher almost immediately. In other words, if everyone used the formula, the bargains would disappear and the magic formula would be ruined.

That's why we're so lucky the magic formula isn't that great. It doesn't work all the time, in fact, it might not work for years. Most people just won't wait that long. Their investment time horizon is too short. Even if a strategy works in the long run, most people won't stick with it. After a year or two of performing worse than the market averages (or earning lower returns than their friends), most people look for a new strategy.

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Identifying the Right Stuff

Most people and businesses can't find investments that will earn very high rates of return. A company that can earn a high return on capital is therefore very special.

Companies that earn a high return on capital may also have the opportunity to invest some or all of their profits at a high rate of return which can contribute to a high rate of earnings growth.

So how does the magic formula find us companies that are able to earn a high return on capital in the first place? To earn a high return on capital, even for one year, it's likely that, at least temporarily, there's something special about that company's business. Otherwise, competition would already have driven down returns on capital to lower levels.

It could be that the company has a relatively new business concept (like a candy store that sells only gum), or a new product (like a hot video game), or a better product (such as an iPod that's smaller and easier to use than competitors' products), a good brand name (people will happily pay more for Coke than for Joe's Cola, so Coke can charge more than Joe's and continue to earn a high return on capital despite having competition), or a company could have a very strong competitive position (eBay was one of the first auction Web sites and has more buyers and sellers than anyone else, so it's hard for new auction sites to offer the same benefits to customers).

Marketplace Advantages

In short, companies that achieve a high return on capital are likely to have a special advantage of some kind. That special advantage keeps competitors from destroying their ability to earn above-average profits. Businesses that don't have anything special going for them are likely to earn only average or below-average returns on capital. If there's nothing special about a company's business, then it's easy for someone to come in and start a competing business. If a business is earning a high return on capital and it's easy to compete, eventually someone will! They'll keep competing until returns on capital are driven down to average levels.

By eliminating companies that earn ordinary or poor returns on capital, the magic formula starts with a group of companies that have a high return on capital. Sure some of the companies chosen by the magic formula won't be able to maintain their high return on capital. But on average, the high-return-on-capital companies chosen by the magic formula are more likely to have the opportunity to reinvest a portion of their profits at high

rates of return. They are more likely to have the ability to achieve high rates of earnings growth. They are also more likely to have some special competitive advantage that will allow them to continue to earn an above-average return on capital. In other words, on average, the magic formula is finding us good companies. Then it tries to buy them at bargain prices.

More Impressive Results

The magic formula has a better track record than I've been letting on. I didn't reveal this good news earlier for a reason. A good track record is not why you should want to follow the magic formula. A good track record is not why you will have good results in the future. A good track record is not why you will keep following the magic formula even when results turn against you. The truth is that a good track record only helps once you understand why the track record is so good. Now that you do — simply put, the magic formula makes perfect sense — I can trust you not to get carried away with a little more good news.

Following the formula for any three-year period in a row, the magic formula beat the market averages 95 percent of the time (160 out of 169 three-year periods tested). That's not all. Over three-year periods, if you followed the magic formula, you would never have lost money. Sticking with the magic formula for any three-year period during those 17 years, you would have made money 100 percent of the time. The worst return for the magic formula was a gain of 11 percent, compared to a loss of 46 percent for the worst return over a three-year period for the market averages.

All of those numbers were based on the results achieved by choosing from only the largest 1,000 stocks. The results from choosing from the largest 3,500 stocks were even better. Every three-year period tested was positive for the magic formula portfolios and every three-year period beat the market averages.

Getting an Accurate Earnings Read

Most people have no business investing in individual stocks on their own. Choosing individual stocks without any idea of what you're looking for is like running through a dynamite factory with a burning match. You may live, but you're still an idiot.

But if you must ... and you can actually predict normalized earnings several years down the road, use those estimates to figure out earnings yield and return on capital. Then use the principles of the magic formula to look for good companies at bargain prices based

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on your estimates of normal earnings. The magic formula doesn't look at future earnings. That's too hard. The magic formula uses last year's earnings which can be very misleading.

In fact, often the near-term prospects for the companies selected by the magic formula don't look so good. In many cases, the outlook for the next year or two is downright ugly. If instead, estimates for this year's or next year's earnings were used, many of the companies selected by the magic formula might not look like such bargains at all.

So what should we be doing? Ideally, better than blindly plugging in last year's earnings to the formula, we should be plugging in estimates for earnings in a normal year. Of course, last year's earnings could be representative of a normal year, but last year may not have been typical for a number of reasons: earnings could be higher than normal due to extraordinarily favorable conditions that may not be repeated in most years. Alternatively, there may have been temporary problems with the company's operations and earnings may have been lower than in a normal year.

If you truly understand the business that you own and have a high degree of confidence in your normalized earnings estimates, owning five to eight bargain-priced stocks in different industries can be a safe and effective investment strategy.

How can owning just five to eight stocks possibly be a safe strategy? Think of it this way. You're a successful local businessman who has just sold off his business for \$1 million. You want to invest that money wisely so that you can safely earn a good return over time. You have the opportunity to reinvest the proceeds from the sale of your business by buying an ownership stake in some of the other businesses in town. You have some understanding of about 30 of those businesses, and your plan is to invest in companies that you understand well, that have a good future and that are available at a reasonable price.

For those companies about which you feel most confident in your ability to make predictions, you project what normal earnings should be several years down the road. You also look for companies that you believe will be able to continue in business for many years and for companies that should have the ability to grow their earnings over time. Then you calculate earnings yield and return on capital based on your estimates for each of those companies. Of course your goal is to find good businesses that can be purchased at bargain prices. On the basis of your analysis, you select your five favorites

and invest \$200,000 in each.

Risk

Does that sound like risky behavior? It would be if you had no idea how to read financial statements or evaluate individual businesses. But if you do have that ability, is buying a stake in your five favorite businesses enough? Would owning a stake in your eight favorites be better? I think most people, especially those who view stocks as long-term ownership stakes in actual businesses, would think that spreading that \$1 million among investment stakes in five to eight bargain-priced businesses in varying industries would qualify as prudent behavior.

At least, that's the view I take with my investment portfolio. The more confidence I have in each one of my stock prices, the fewer companies I need to own in my portfolio to feel comfortable. Most investors view stocks and the construction of stock portfolios differently however.

Somehow, when ownership interests are divided into shares that bounce around with the market's moods, individuals and professionals start to think about and measure risk in strange ways. When short-term thinking and overly complicated statistics get involved, owning many companies that you know very little about starts to sound safer than owning stakes in five to eight companies that have good businesses, predictable futures and bargain prices. In short, for the few who have the ability, knowledge and time to predict normal earnings and evaluate individual stocks, owning less can actually be more — more profits, more safety and more fun. ●

Part Five: Investing Fundamentals

On Wall Street, money won't magically appear under your pillow. There's no one to tuck you in, no one to take care of you and no one you can turn to for good advice. You're on your own.

To see why this is necessarily so, assume you have some money you would like to invest over the long term. Second, you would like to earn as much as possible from your investments, but you are unwilling to take unreasonable risks. Finally, the stock market offers the best possibility for high investment returns over time and this is where you would like to put your money.

- One typical stop is our friendly neighborhood stockbroker. This is an investment professional whose job is to hold your hand and help you invest

Magic Formula Investing

Step 1

Go to magicformulainvesting.com.

Step 2

Follow the instructions for choosing company size (e.g., companies with market capitalizations over \$50 million or over \$200 million). For most individuals, companies with market capitalizations above \$50 million or \$100 million should be of sufficient size.

Step 3

Follow the instructions to obtain a list of top-ranked magic formula companies.

Step 4

Buy five to seven top-ranked companies. To start, invest only 20-33 percent of the money you intend to invest during the first year.

Step 5

Repeat step 4 every two to three months until you have invested all the money you have chosen to allocate to your magic formula portfolio. After nine-10 months, this should result in a portfolio of 20-30 stocks.

Step 6

Sell each stock after holding it for one year. For taxable accounts, sell winners after holding them a few days more than one year and sell losers after holding them a few days less than one year. Use the proceeds from any sale and any additional investment money to replace the sold companies with an equal number of new magic formula selections.

Step 7

Continue this process for many years. You must be committed to continuing this process for a minimum of three to five years, regardless of the results. Otherwise you will most likely quit before the magic formula has a chance to work.

your money. Your stockbroker will help you choose between individual stocks, bonds, investment funds and other investment alternatives. If your stockbroker is like the vast majority, he or she has no idea how to help you. Most get paid a fee to sell you a stock or a bond or some other investment product. They don't get paid to make you money.

- You might as well just put your money in a *mutual fund*. Here's the perfect solution for the small

investor. A mutual fund is an investment fund managed by a professional money manager who selects a diverse group of stocks or bonds. This is a particularly efficient way for a small investor to spread his or her investments capital over a wide group of different investments. The problem is that it's tough to have specific insight into many different companies and investment securities. Then of course, there's the small matter of fees. Basic math says that average returns minus fees equals below-average returns.

- Instead, you might consider investing in a hedge fund. These are exclusive private investment funds usually reserved for very wealthy investors. Unfortunately, in most cases, unless you already have at least \$500,000 or so to invest, you probably won't even have this option. By law, most hedge funds can only accept investors who can afford to lose large amounts of money. Hedge funds are investment funds that have more flexibility than most mutual funds. Managers can use the fund's capital and borrowed money to buy a large variety of securities. They are able to place bets on whether stocks, other securities or entire market averages will move up or down. Most mutual funds are restricted to making money only when the securities they own go up. A hedge fund's ability to bet up or down over many different securities, often with the aid of borrowed money, is seen as a big advantage over most standard mutual funds. But most hedge funds charge huge fees — at least 1 percent of assets under management plus a 20 percent share of the profits.
- So that's why many people just choose to invest in an index fund. An index fund is a mutual fund that just tries to equal the overall market's return, less a very small fee. These funds pick a market index and buy all of the stocks in that particular index. Although this strategy won't help you beat the market, it will help you achieve returns that are at least close to the market averages.

The magic formula and the principles behind it to guide your future investment will remain one of your very best investment alternatives. I believe that if you are able to stick with the magic formula strategy through good periods and bad, you will handily beat the market averages over time. In short, I believe that, even after everyone knows the magic formula, your results will continue to be not only quite satisfactory, but with a little luck, extraordinary. ●

· Book 34 of 44 ·

Summary



How You Can Profit by Investing in Asia's Newfound Prosperity

The Silk Road To Riches

THE SUMMARY IN BRIEF

The original "Silk Road," a vast network of ancient trade routes, connected Asia with the West. Goods and ideas traveled this road enhancing the lives of millions of people. A Silk Road for a new era was begun in May 2005 at the annual meeting of the Asian Development Bank as 13 Asian nations moved a step closer to creating an Asian monetary fund and establishing more regional financial integration.

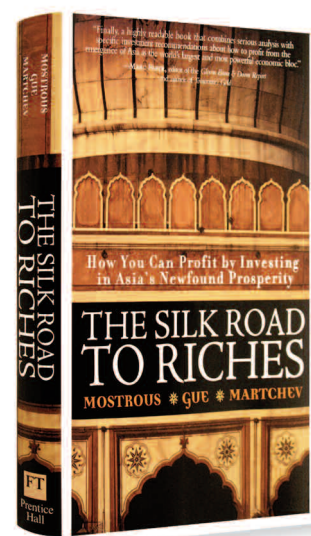
Asia is now the world's No. 1 growth story. Profits will be made by investing in companies that benefit from Asia's historic transformation. In *The Silk Road to Riches*, a team of world-class financial analysts and newsletter editors point you to the right companies, the right sectors and the right strategies. This is a guide for the long-term investor.

The authors offer powerful support for several provocative claims: that India, not China, is Asia's best investment destination; that the price of gold is poised to explode; and much more. They illuminate global economic changes that will decide the fate of the U.S. dollar as the world's reserve currency and present an overview of crucial global security issues every investor must understand, no matter where they invest.

The amount of analysis and understanding of developing economies presented in this summary will help those who read it to participate in and profit from the enormous transformation taking place as emerging economies develop their respective capital markets.

IN THIS SUMMARY, YOU WILL LEARN:

- How to leverage Asia's accelerating integration into the world economy.
- How to profit from the pressure that Asia's growth is placing on commodities and resources.
- The differences between the Asian super giants, China and India.
- How to anticipate the needs of Asian consumers in a variety of industries.



By Yiannis G. Mostrous,
Elliott H. Gue,
and Ivan D. Martchev

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THE COMPLETE SUMMARY: THE SILK ROAD TO RICHES

By Yiannis G. Mostrous, Elliott H. Gue, and Ivan D. Martchev

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PART I: IT IS ALL ABOUT THE PEOPLE

A New Middle Class

A recurring theory throughout the centuries that has not yielded tangible results has been that Asia can become the engine of global economic growth. Based on a perceived inability of the region to deliver on its potential, many investors resist the idea that Asia can develop a sustainable, consumer-based economic growth model. Such resistance is rooted in the region's well-documented dependence on exports to the Western economies. Asia, in this construct, is destined to remain stuck in a volatile boom-and-bust cycle.

But consider the following set of circumstances: a large population with the demographics of a high savings rate, an increasing bias toward consumption, and the fact that the world needs a new growth engine for the 21st century. These elements portend a rise of the Asian consumer that will transform the global economy.

Looking Back

Few people appreciate the fact that parts of Asia, especially parts of China, Japan and India, were on the same economic level as Europe until the end of the 18th century. This lack of appreciation, coupled with Europe's spectacular economic growth in the 19th century, led to unshakable misunderstandings when the West did business with China in particular.

Of course, this is a two-way street; Asia's own attitudes harmed it numerous times. In the 1990s, Asian leaders and businessmen accepted the theory that there was something unique about Asia that made its economies thrive. But a careful look reveals that the region's success was more the result of good timing than anything else.

The Old East Asia Economic Model

The basis of the East Asia Economic Model (EAEM) is that Asia satisfies the world financial system's demand for a source of cheap labor for developed economies. This EAEM has created huge surpluses in Asian countries, while suppressing demand and limiting their domestic growth to the amount of foreign direct investment it receives and exports. As the Western economies condition themselves to low-priced products, Asia's role in this system is becoming more important.

Both parties — Asian producers and Western consumers — have accepted their respective EAEM roles. The EAEM is based on export volume and depends on foreign demand and foreign direct investment. This giant export machine helps Asian countries grow, while the accumulation of savings by the Asian people allows consumers in the developed countries to expand their seemingly insatiable consumerism to unprecedented levels.

For the time being, Asia gladly serves as the facilitator of Western economic growth. Its economies are growing and modernizing. Yet, the moment will arrive when average Asians will demand more for themselves, and governments will be forced to spend more resources supporting their own domestic economies. ●



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Time Is On Their Side — The Demographics Of Asia

Asia is home to 3.5 billion people, 57.5 percent of the world's population. Beyond the raw numbers, Asia's demographics are extremely impressive and important. Asia has what researchers call demographic advantage. The region's dependency ratio continues to decrease and the segment of its population in their 30s to 50s (high earners and spenders) is expected to grow dramatically in the next five to 10 years.

Another important factor is lifestyle changes. Many young people in Asia now have a career-oriented singles lifestyle. In Thailand, about 34 percent of households today have no "economically dependent" children as greater numbers of women are entering the workforce while opting for fewer children. As the urbanization of Asia continues, these trends should persist and become the norm.

The Potential and the Challenge

It is true that it will take time for the Asian consumer to replace the American as the primary global consumption driver, and that it will take a lot in absolute terms for Asia's middle class to catch up to Western standards. However, in relative terms, the results so far are impressive and improving rapidly.

A crucial assumption about the region's future spending potential is that, as economies in Asia continue to grow, the income for distribution will also increase, expanding the region's middle class. This is already happening — the income distribution in Asia is improving, a good sign for future consumption, as well as for social stability.

Since 1997, Asia has made great progress in improving its financial system, but the region's sustainable growth requires nothing less than total banking reform. Although Asia needs money for development, it still cannot properly exploit its huge surpluses given the financial system's functional problems. A regional liquidity system must be established so that Asia can use its savings and other funds for investments without the interference of others. Only if Asian governments succeed in this respect will Asian countries and their citizens attain steady economic growth through sustainable domestic demand.

Eventually, Asian governments will be forced — either by social pressure or by economic circumstances — to structurally boost domestic demand. The current

model of economic growth will lead to prolonged economic slumps and will create social problems notoriously more difficult to solve than anything else. At a later stage, a structural rise in Asian wages relative to the United States and the developed world may take place. Domestic institutional and individual investors could provide the next level of support for the Asian countries. If governments and people work together, the next investment/consumption boom in Asia can be domestically driven, relative to the real economic situation of each country, and be more sustainable. ●

Asia's Path To Prosperity

The collapse of the Asian economic "miracle" in 1997 was a devastating economic and social shock for the region. Marc Faber, author of *Tomorrow's Gold: Asia's Age of Discovery*, wrote, "I had never read about, or seen the kind of total economic breakdown and wealth destruction — on such a massive scale, in such a short period of time, and against all expectations — as we saw in Asia in the six months following the onset of the crisis." Investors all over the world felt the consequences.

Theories abound as to why the Asian miracle ended in such a spectacular fashion. The most discussed are panic, crony capitalism and moral hazard in lending. A combination of crony capitalism and moral hazard in lending is the most credible.

Now the question is: Has Asia established the necessary conditions for sustainable economic growth, even in the event of a U.S.-led economic slowdown? The quick answer is yes. The expansion of trade and Asia's growing role in it will prove to be the main force in establishing the region as an important part of the world's economy.

Outsourcing

Outsourcing — an appalling word to millions of people in developed economies — is nothing more than an effort by a company to produce part of its products (in which it has no comparative advantage) elsewhere. Given that consumers have been conditioned to expect lower goods' prices while developing an increasingly lower threshold for pain, outsourcing will continue despite occasional cries over lost jobs and "inferior service" from abroad.

Outsourcing is not confined to developed countries. Outsourcing and reduction in tariffs are two parameters of the intraregional Asian trade phenomenon. Outsourcing to gain comparative advantage has reached such levels in Asia that companies there outsource among

Summary: THE SILK ROAD TO RICHES

each other, based on relative position in the production chain. Meanwhile, more than 90 percent of trade among Asian countries is conducted in a context of tariffs between 0 to 5 percent.

Another factor in strong intraregional trade is the steady incorporation of China into the global economic system. China's domestic growth allowed U.S., Japanese and European Union companies to increase their exports during the 2000-01 global economic slump. This made companies around the world realize that there is more to China than cheap production.

Exports and China are the two strongest forces in the Asian growth arsenal, whereas consumption is slowly and steadily growing in importance. Asia is gradually finding itself in a favorable position in the world economy.

A Changing World

The argument that Asia aims to "take over the world" is nothing more than a base appeal to emotion in place of logic. One of the main tenets of this position is that "imports from countries where labor is cheap cause unemployment in the United States." But if developing economies are able to raise productivity to Western standards, wages will rise there too; Japan proved this. Constant change is what capitalism is all about. This is what the "sensationalists" fail to understand: The world will not come to an end, but rather will adjust to the new economic order.

One of the most important changes in the new economic order will be the adjustment in world wages. The Western world will experience decreasing wages, whereas the East will enjoy the opposite. This shift will take place at a relatively slow pace. These changes will coincide with a decrease in asset prices in the West and a corresponding increase in the East because of changing income levels. The benefits will be universal as consumption will increase due to rising incomes and the integration of China and India into the global economy.

Integration into the Global Economy

For Asia to be able to take advantage of the current global economic situation, governments must find ways to create an environment that will foster sustainable domestic demand. Asian countries need to take advantage of their particular indigenous characteristics while focusing their efforts toward domestic investments.

These countries have held their own in manufacturing, but need to move up the chain from low value-added mass manufactured products to a higher pricing-power

export industry. They must also take advantage of domestic natural resources and spend money on domestic-related investments. The ultimate goal is to create the necessary conditions for domestically driven economic growth. It remains to be seen whether the respective governments have the capacity, first, to develop this strategy and, second, to execute it.

Wealth distribution is improving in Asia, but financial security remains the privilege of a few. If the improving wealth distribution trends stop, it will be virtually impossible for the scenario thus posited to unfold. But it will also be impossible for governments to continue ignoring their people. This means governments must shift attention to domestic investment in infrastructure, including agriculture, and shift attention from urban centers to rural areas of their countries.

Lessons Learned

Looking at Asia today, there is a sense that many things have changed for the better. Current account balances have gone to surplus, foreign exchange reserves have been rebuilt and dependence on short-term capital inflows has diminished. Positive cash flow has become the name of the game and Asian companies are expected to stay on this course for years to come.

These factors have allowed Asian companies to become more shareholder friendly by increasing dividend-payout ratios. Dividends have grown substantially since the mid-90s and investors can expect dividend growth of at least 7 percent per year in the future. Asian companies now realize that making money is more important than increasing sales at any cost.

The prospect of a crisis of some sort must not be ignored. However, for Asia in general, and China and India in particular, the inevitable downturn should be viewed as a small detour on the way to joining the capitalist economic system. ●

The Great Comparison — The Elephant And The Dragon

One of the most important international events of 2003 was India's Prime Minister Atal Bihari Vajpayee's state visit to China. During that visit, the two leaders signed a Declaration of Cooperation and nine protocols on bilateral cooperation, normalizing Sino-Indian relations. Two years later, Chinese Premier Wen Jiabao visited India and signed more agreements on trade, border issues and the development of new energy sources.

Summary: THE SILK ROAD TO RICHES

China's and India's willingness to put aside their historical differences and concentrate on their mutual economic growth is viewed as one of the most important global developments of the 21st century thus far.

India: A Powerful Force

In 1991, India endured its biggest economic crisis; foreign exchange reserves were down to three weeks' worth of imports. With the country on the brink of collapse, drastic change was instituted; the rupee was devaluated, import controls dismantled, duties were slashed, industrial licensing liberalized and capital markets were opened. These pivotal moves allowed India to emerge as a deregulated economy in the global market. In the four years after the crisis, India's economy grew by 6.7 percent per year.

India's progress is not in question. But for the long-term investor, certain characteristics make its story much more interesting and desirable than any other in Asia.

Characteristics of India's economy include:

- Banks in India have been fairly conservative, maintaining the rate of nonperforming loans at a low 8.8 percent of total lending (as of March 2003).
- Its capital markets are among the most developed of the emerging economies and they operate with greater efficiency and transparency than China's.
- The legal system is fairly independent and acts with integrity (although it lacks efficiency). Property rights in India are protected and the rule of law, albeit with a time lag, usually prevails.
- The entrepreneurial spirit of its people is world-class.

Problems Abound

The elected leaders of India seem to have a good reform plan in place. And in India's case, "Reform is about removing the obstacles to it." The main obstacles are corruption and inefficiencies, especially in the state and lower levels of government. Acknowledging that urgent improvements are needed, India made the decision to use part of its foreign exchange reserves to fund domestic infrastructure projects, a government action without precedent in the world, but one that seems unassailable in light of statistics showing that most infrastructure services costs are 50 to 100 percent higher in India than in China.

Democracy and Growth

As progress in India continues, it is the country's middle class — more than 150 million strong — that is most affected by the changes. This is a huge consumption market, but one must always be aware of the potential for social unrest.

The big challenge is to extend the benefits of progress to the lower levels of Indian society; otherwise the country could enter a period of economic destruction and social unrest.

So far, India has followed the correct path toward economic development, one charted by monetary targets (for example, inflation and a balanced budget). This approach, the results of which are less obvious in the short term, is a long-term creator of economic stability and growth.

China: Waking Up

As with almost every other Asian country, China has followed a model of growth based on manufacturing. Therefore, China's immediate economic future is tied to a high degree to global demand and the relentless cost-cutting actions of corporations around the world. The country's low-cost production setup makes it conceivable that manufacturing-related industries can all eventually be relocated to China.

While such a move makes economic sense, not many are willing to discuss the viability of this development given the socio-economic distortions and political costs involved. But two things are certain: The trend is continuing, and China is doing everything in its power to steer the global economy in that direction.

Solving Problems

China has many daunting problems to solve on almost every level of its economy and its society. The challenges faced by the Chinese leadership will require it to be extremely flexible and creative.

The main issues for investors can be reduced to these questions: Have the leaders of the Communist Party understood the problems and decided on a proper course of action, and will they be successful? For investors, direction is far more important than current status, and China is heading in the right direction.

The Time Factor

Some critics maintain that China will be incapable of transforming itself and will eventually collapse under the weight of its internal dysfunctions.

Gordon G. Chang is the most vocal critic and in his book, *The Coming Collapse of China*, he writes: "If China had, say, 30 years, everything might come out right. But whether China is on the right road is not the matter at hand. When historians write the final chapter on the People's Republic, they will say that there wasn't enough time."

Chang's approach centers on the "moral collapse" of the Chinese society and the lack of political reform. His

point is that corruption remains the biggest problem the Chinese leadership has to solve. This brings up the point again that investing in an emerging market environment has always entailed danger. However, there are ways for an investor to profit from the changes that are taking place in China even if the current reforms fail and total chaos prevails as Mr. Chang expects. ●

PART II: THE RISKS INVESTORS MAY ENCOUNTER

Power Games

Global and regional geostrategic developments are of immense importance when making long-term investment decisions. Those who understand the purely economic reasons for the new relationships will prosper.

The resolution or clarification of the following issues will have global consequences:

- China's political ambitions and military capabilities
- India's desire for first-world power status
- The outcome of the United States–Russia–China race for influence in central Asia
- Russia's role as a vital source of energy
- The potential Korean unification
- Iran's importance to Asia
- Japan's future security needs
- U.S. involvement in Asia and how it affects the changing geopolitical landscape in the region.

These issues are interrelated and therefore extremely complicated, but one central conclusion can be drawn: The post-World War II status quo in Asia is unwinding.

Looking at the Long-Term Returns

There are two main categories of stock markets, developed and emerging. Among the developed markets, the United States comprises about half of world stock market value, and the American economy accounts for about a third of the global economy. Due to its sheer size, in the end, everything comes down to the United States. If cracks appear in the U.S. stock market or economy, the world's major markets shake.

The most common misconception about stocks is that their long-term average return is “guaranteed.” The most widely advertised long-term annualized return for stock is usually quoted as 11 percent. But, if the market is flat for a decade or two, any substantial

deviation from the 11 percent return assumption can be devastating.

Ultimately, stock prices reflect the earnings power behind the companies issuing the stocks. Clearly, stock prices can deviate substantially from the earnings power they represent, but over the long term, that is not likely to be the case.

There are only two ways that stocks can become cheap compared to previous bear market bottoms. Either prices will decline precipitously, on the order of 50 to 70 percent, or earnings and dividends will double or triple in the next 10 years. A probable development in the market cycle is a substantial decline in prices in the next five to 10 years.

Unsustainable Macroeconomic Imbalances

In a perfect world, a free market without intervention would take care of most imbalances in an economy. But when vested interests cross swords, the story changes dramatically.

At present, the United States requires close to \$2 billion net inflow of capital every day to finance the trade deficit. No one can say definitively that creditors will stop the financing binge, but, before that number grows to \$3 billion, it is likely that our creditors will say, “Enough is enough.” It is likely that there will be a crisis by the year 2010 with the trade balance at its current proportion and growth rate.

The large and growing current account deficit can put tremendous pressure on the dollar, which still serves as the reserve currency of the world. If foreign central banks and large institutional investors decide to diversify away from dollar assets — a process that has already stealthily started — that will accelerate the currency decline to crisis proportions. Nothing is worse than a sinking currency to a heavily indebted economy like the United States.

Of note, the United States is the only country that can pay its rising debts with its own currency, currency it prints at its own discretion. Because of this luxury, the macroeconomic imbalances the United States faces will likely become a lot larger, making the unwinding of those imbalances more painful when it happens.

Bubble All the Way

When trying to define a bubble as economic or stock market related, there is always one common ingredient: the extension of too much credit. Ample credit shifts economic activity into overdrive and

Summary: THE SILK ROAD TO RICHES

ends up pouring a lot of money into too many unproductive uses.

A very basic principle describes the unwinding of bubble markets: full retracement to the point where the bubble started. Full retracement for the Dow Jones Industrial Average is estimated to be at the 4,000 level, which corresponds to roughly 500 on the S&P 500 and 800 on the NASDAQ Composite. There is a high probability this will happen within the next five years, 10 years at the most. ●

PART III: TRENDS OF THE FUTURE

Agriculture, Energy And Metal Commodities

The New Agricultural Revolution

The global agricultural industry is facing a demand crunch of proportions unseen since the Industrial Revolution. China, India and other emerging economies across Asia support a combined population of over 3 billion, more than half the global population.

Fortunately, an agricultural revolution is underway that will allow the global economy to meet these new demands. Vast improvements in transportation and containerized shipping technology allow even perishable items like fruits and vegetables to be transported vast distances at negligible cost. Asia's growing demands for complex items like meats, fresh items and processed and packaged consumables will rely on imports from other regions such as the United States, Europe and Latin America. Key companies producing goods in high demand across Asia are already seeing a massive jump in trade.

Fueling Global Growth

Higher prices are the only proven way to ration demand for any commodity over the long term. Burgeoning Asian demand for energy, coupled with slow production increases in the coming years, means that the era of low energy prices is over.

The Refining Factor — The refining business is booming for one simple reason: Demand for gasoline globally outstrips the capacity to refine crude. In coming years, well-placed refiners will enjoy widening margins.

Coal — Coal remains king throughout most of the developed and developing world. It still accounts for more than half of the electricity generated in the United States and about 40 percent of global electricity generation. It is a particularly important fuel in Asia, accounting

for more than 75 percent of electricity generated in both China and India.

Natural Gas — Natural gas has several advantages over oil or coal: There is more of it and it is far cleaner to burn. According to the Energy Information Administration, natural gas will be the fastest growing source of energy globally between 2005 and 2025.

Nuclear Power — The world is rapidly recognizing the advantages of nuclear energy and the industry is entering a period of global growth. This growth is putting a strain on the world's available uranium production capacity.

Renewable and Alternative Energy — The truth is that existing renewable energies, wind, solar and hydro-electric power, will never be able to fully supplant fossil fuels. Expect solid growth for renewable energies but from a low starting point.

Integrated Oil Companies — They offer a little bit of everything: refining, exploration, production and retail sales of petroleum products. The best companies are at the forefront of key trends in the energy markets, including liquefied natural gas (LNG), deepwater exploration and refining capacity. ●

Asia's Evolving Economics

A rapidly growing and expanding Asian middle class will start to demand many of the same goods and services as their counterparts in developed Western economies. Asia's enormous middle class will be the largest group of consumers to ever be integrated into the world economy.

In general, the growing consumer base will require increasingly advanced financial services — banking, credit cards and mortgage loans — to manage growing incomes. Consumers will also want to spend their new wealth on clothes, eating out, holidays and entertainment. The financial and leisure industries in Asia will see tremendous growth in coming years.

Travel and Tourism

There are two primary ways to play the Asian travel trend: the airlines that carry all these new passengers and the hotels with large exposure to these markets.

Several airlines using the Southwest Airlines "low-cost" model are springing up all over Asia. That competition will likely prove a boon to the industry in the way of falling prices. As more Asians conclude they can afford to travel, competition will simply fuel growth for the industry.

Summary: THE SILK ROAD TO RICHES

Rapid growth in domestic travel, business travel and international tourism is driving the hotel market in Asia. The world's largest hotel chain, Intercontinental Hotel Group, has the biggest presence in Asia of any main international chain. Its flagship brand is InterContinental, but it also includes more common worldwide brands such as Crowne Plaza and Holiday Inns.

The Necessities

Consumption of packaged and prepared foods, beverages and fast food restaurants are seen as staple products in the Western world and growth in this industry, while steady, is slow. In Asia, revenue growth in consumer staples has soared to double-digits annually in these markets. Coca-Cola, for example, reported sales growth in 2004 of just 2 percent worldwide but more than 20 percent in China.

Consumer products are one industry where Western brands hold a huge advantage over their local domestic counterparts. The best global brands tend to attract considerable loyalty in China and India, even if they cost more than equivalent local brands.

Global consumer tastes tend to converge as consumers reach equivalent levels of wealth. Thus, local foods and tastes, although important, can give way to global food styles and brands.

Western brands hold two major advantages in Asia: branding and distribution. Western companies have the ability to enter Asia with multibillion-dollar advertising budgets and the scope to set up large distribution centers so they can achieve economies of scale and offer lower-cost sourcing for goods.

Retail

The consumer's influence is finally reaching critical mass in most of Asia. As incomes continue to rise in the region, Asia will develop a culture of consumerism similar to what exists in the Western world.

In China, the concept of hypermarkets that include a supermarket and a department store rolled into one are growing in popularity. Also, traditional Western luxury brands have made big inroads into the Chinese market for two reasons: Chinese consumers want Western luxury goods to enhance their social image and there are enormous numbers of wealthy Chinese capable of affording luxury merchandise (despite the fact that the rich represent a tiny proportion of the total population).

Another change factor is the rise of women as key consumers in the traditionally male-dominated region.

As the spending power of women in general rises, Asian women are increasingly buying similar items as their Western counterparts.

Also, the concept of the big-box discount store (a la Wal-Mart) is spreading. Wal-Mart is expanding its already considerable footprint in China to enhance its supply chain. According to the *China Daily*, if Wal-Mart was a separate country, it would be China's eighth largest trading partner.

Banking and Finance

Robust economic growth and a rising middle class will fuel strong lending growth in both China and India. India however, is likely to see the faster, more sustainable growth as evidenced in its loan to GDP ratio (total loans outstanding in the economy divided by GDP) of 35 percent compared to China's loan to GDP ratio of 140 percent. Also India has agreed to adopt the internationally recognized Basel II accounting standard for capital adequacy by the end of 2007.

Pharmaceuticals and Healthcare

India already has well-developed expertise in the healthcare business. Indian manufacturers account for more than one-third of all filings in the United States for generic drug approvals, and the nation has the highest number of FDA-approved manufacturing facilities outside the United States. Indian drug companies realize they must take the next step and develop their research and development capabilities, because in this regard they have a competitive cost advantage. A handful of foreign companies will benefit from growth in Asia by selling into the market and by sourcing at lower costs in India.

Technology/Outsourcing

China and India are emerging as key centers of technological innovations. The region holds the advantages of education, since science and engineering degrees are popular and the cost advantage, since R&D operations are less expensive in Asia. ●

Down The Silk Road

What's important to remember is that, given the challenges ahead, a great deal of cooperation is required for the world to be able to embrace the new economic order and continue to prosper. Cooperation will take center stage as people around the world begin to realize that policy inflexibility cannot offer answers to today's complex geopolitical, social and economic problems. ●

· Book 35 of 44 ·

Summary



Grow It, Protect It, Spend It, And Share It Wealth

THE SUMMARY IN BRIEF

Everyone dreams of striking it rich — by selling a business, scoring a great investment, receiving an inheritance or winning the lottery. Stuart E. Lucas was one of the fortunate ones who was born into a wealthy family. His great-grandfather, E.A. Stuart, began with \$25,000 and founded the Carnation Company. Eighty-six years later, the company was sold for \$3 billion to Nestlé.

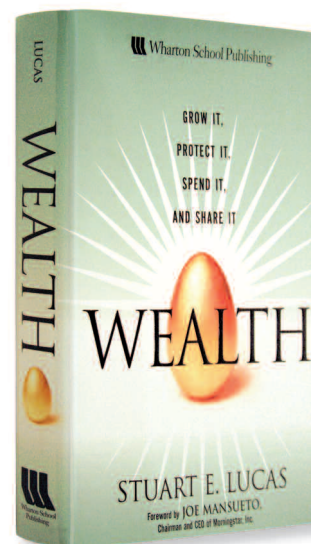
Lucas has been able to draw a unique perspective on wealth management from experiencing first-hand the thoughtful family legacy created by E.A. Stuart. The legacy included how to run a business and manage the wealth that a business creates.

In *Wealth*, Lucas shares this perspective and utilizes his 25 years as a professional wealth manager to build a flexible framework that can be customized to the unique circumstances of anyone concerned about wealth creation, wealth management, families with wealth, retirement planning and multi-generational estate management.

Lucas shows how to use this framework to protect and grow your personal and family wealth whether you are worth a few hundred thousand dollars or a few hundred million. Wealth management is not just about money, Lucas tells us, it's also about people, relationships, values, doing well by doing good and, of course, family. Wealth is a gift to be safeguarded, nurtured and shared productively with others.

IN THIS SUMMARY, YOU WILL LEARN:

- How to manage wealth received through inheritance.
- The eight principles of Strategic Wealth Management.
- How to define your values and objectives.
- How to select the right financial administrator.
- Why taxes are your ally.
- How to strike the right balance of risk taking, wealth preservation and leadership.
- How to prepare your children to be stewards of your wealth.



by Stuart E. Lucas

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THE COMPLETE SUMMARY: WEALTH

By Stuart E. Lucas

The authors: **Stuart Lucas** is a fourth-generation heir to the Carnation fortune and also a wealth management advisor. Lucas has filled the posts of Senior Managing Director of private client services at Bank One, General Manager of European Operations at the Wellington Management Company, as well as the Assistant Portfolio Manager of a Forbes Honor Roll mutual fund.

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How the Wealth Industry Works

You need knowledge to protect your interests. If you are not a proactive, thoughtful and informed client, the wealth-management industry actually works against you in three ways:

- When clients' and advisors' goals conflict, advisors may put their own interests ahead of their clients.
- Advisors are unlikely to understand or appreciate the personal and family dynamics that drive your wealth-management goals.
- Very few wealth-management professionals fully understand how the advice of one expert can potentially affect that offered by another.

Furthermore, it is not easy to measure the value added that a wealth-management firm or advisor generates for a client. This could leave you in the position of having to trust your advisors without an accurate yardstick to measure their effectiveness.

Classic Approach to Wealth Management

When selecting wealth-management advisors, prospective clients try to absorb the sales pitches with limited relevant experience. They then typically pick the most attractive-sounding presentation without a thorough understanding of what they want to achieve or the likelihood of doing so.

Since most private wealth advisors don't generate revenue until they have sold something and because many clients want the security of knowing their assets have been invested, solutions are quickly implemented. This

leaves little incentive for advisors to explain the pros and cons of all the financial options available, especially low-cost, high-value ones.

Within a month or two, the client's strategy is set, the assets fully invested and the revenues are flowing to the advisor's firm. From here on out, the advisor meets periodically with the client to review the portfolio's performance, to offer suggestions for improvement and to make any agreed-upon changes.

Strategic Wealth Management

Strategic Wealth Management offers a new way to structure your wealth management. It is a holistic approach that explores all your strategic options while showing you how to employ your advisors to greatest effect. It focuses on your interests, putting you at the center of the framework, and it explores your values, your skills and resources and how you relate to your family.

The external context in wealth management includes the tax code, estate-planning laws and philanthropic interests. When these are coupled with your family's dynamics, you can set appropriate financial objectives and organize the right advisors to execute your wealth-management strategy.

It's Not Only About Money

Wealth aside, no two families are alike. They are complex, dynamic organisms that are forever changing. They consist of each member's beliefs, values, attitudes, norms and behaviors. Money can help a family pursue extraordinary opportunities. However, it can also foster resentment, create dependency and even lead to corruption. This is why you must take charge of your



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wealth management by assuming the role as your family's "Wealth Strategist." ●

Eight Principles Of Strategic Wealth Management

A useful set of principles for effective long-term wealth management, which can be applied equally well to managing a nest egg of \$1 million or \$1 billion, regardless of time and family complexity, and whether your ambitions are aggressive or conservative, can be outlined as follows:

1. Take Charge and Do It Early:

You must educate yourself about your family finances and decide how to structure family and financial goals so they can become integrated and reinforce one another. If this is not done early, forces such as taxes, fees and inflation can erode your family's wealth. After you and other family members define your values, you'll have a basic template in place to develop a long-term strategy.

2. Align Family and Business Interests Around Wealth-Building Goals and Strategies:

Creating strong alignment of family members around common goals is critical to ensuring successful implementation of wealth-management strategies and goals — especially when they are multigenerational. As the Wealth Strategist, your job is to establish a legitimate rationale for people to want to work together.

You also must be adept at focusing wealth-management discussions not only on a family's history and values but also on its vision for the future. It's equally important to ensure that that advisor interests are aligned with yours.

3. Create a Culture of Accountability:

Wealth management is a business activity, and to successfully implement your strategies, you need to put accountability systems and performance metrics in place. You need a benchmark to judge the performance of the Wealth Strategist and the team of advisors. This will reinforce business goals, set expectations and drive the implementation of wealth-creation strategies.

4. Capitalize on Your Family's Combined Resources:

A family's resources become distributed among its members over time, and as assets become distributed there's a tendency to manage them separately. The

challenge is to figure out how and how much to reassemble these distributed resources so they function more effectively. Disciplined family leadership is key. But this does not only include financial resources. You must also look within to examine the combined strength of family members' personalities, experience, skills, affiliations and networks.

5. Delegate, Empower and Respect Independence:

Supporting family members to identify and pursue challenges that they can call their own, away from the family's immediate influence, encourages self-reliance and risk-taking. Furthermore, it encourages the personal growth of young adults who can learn to embrace responsibility and develop a sense of self-confidence.

6. Diversify, But Focus:

Diversification and focus combine the best of both worlds. Diversification protects your wealth by investing over a broad range of areas, and focus provides the intensity that most people need to succeed in life. Without the focus to develop investment skills that are superior to most professionals, you won't add value to your investment portfolio.

7. Err on the Side of Simplicity When Possible:

The more complex the wealth-management strategy, the more variables you have to worry about managing, and the more difficult it is to reverse course. In addition, these schemes — often highly remunerative for advisors at the time of sale — can subject clients to long-term risks. Therefore, before choosing complex solutions to wealth-management issues, evaluate the simple ones.

8. Develop Future Family Leaders With Strong Wealth-Management Skills:

To build and maintain wealth over multiple generations, you must develop future family leaders. However, no person in the next generation should come into the family business without spending at least a decade succeeding outside the family business, preferably in a related field.

Nepotism Can Be A Good Thing

Part of leveraging the scale of wealth is learning to take advantage of talents or business skills that your family members may possess. Putting family talents, skills and resources to good use is every bit as important to sound

wealth management as shrewd investing, strategic thinking and the clear enunciation of values.

Unfortunately, Americans have an ambivalent attitude about nepotism. Yet with the right combination of leadership, resources and structures, families can strengthen themselves through a focus on “nepotistic advantage.” This can help to reinforce positive family values and equates privilege with responsibility, ownership, commitment and accountability among family members.

Everything Begins With Values

For most of us, discussing money and wealth is difficult to do, especially in a family context. Yet having these discussions is critical for purposes of wealth-management planning and choosing the appropriate investment approaches, vehicles and timeframes to meet your needs.

What do you want to accomplish with your life and your wealth? You might want to:

- **Maximize financial security in retirement.**

You must take charge of managing your wealth if you want to live well throughout your lifetime and pass wealth on to future generations.

- **Channel your assets into additional wealth-building.** Two important things about allocating your capital are: Don’t allocate all your capital to one venture; always diversify your investments to mitigate the risk of large-scale market or business losses. Second, diversify the rest of your assets across a range of investments that have little in common with your career or your speculative business venture.

- **Create a special place to bring family together.** A vacation home can become an emotional homestead, a place to go on special occasions to nurture family bonds, enjoy a sense of community with those you love and create a retreat from pressures of everyday life.

- **Become a collector.** Collecting art or other objects can serve many purposes: fun, to build wealth, tax incentives, perhaps a family legacy in its community.

- **Donate money and/or time to worthy causes.** By “giving back” we strengthen the communities to which we are bound and make them more effective for the generations that follow us.

- **Give money and companionship to people you care about.** Financial gifts of cash, property, valuable objects or family heirlooms mean more when they celebrate the special relationships between benefactors and beneficiaries that come through shared experience. Bequeathing money across multiple generations goes far

beyond normal wealth gifting. To do it well means doing it as part of a contract of values that you and your family establish in this generation and which future generations of your family will respect when it is their turn to be stewards of your wealth and values.

Communicating About Wealth

The family culture you establish will have an impact on your children and grandchildren even if your financial assets do not. Thus, it is important to nurture a spirit of kinship among family members by identifying and reinforcing common family interests and wealth-management objectives. This should include all family members who are likely to benefit from it, even the youngest ones.

At the same time, review how wealth is to be used and what responsibilities each member will have. Such open communication is necessary to show the next generation that the privileges of wealth come with responsibilities that include maintaining family values. ●

Defining Your Financial Objectives

After you articulate the values you want to use as the basis for managing your wealth, you need to translate them into financial objectives. You are more likely to achieve your goals — and more important, gain true satisfaction — if your financial goals and values are aligned. First, though, you must select a “distribution-driven” or a “growth-driven” wealth-management style.

Distribution-Driven Vs. Growth-Driven

Distribution-Driven: A distribution-driven wealth-management strategy is built around financial goals that may include:

- A time horizon of 20 years or less.
- A high level of spending without concern of passing wealth on to the next generation.
- A lower rate of return since your assets only have to last your lifetime.
- Simple investment, tax and estate-planning strategies.
- Current gifts to satisfy your philanthropic desires.

Growth-Driven: A growth-driven wealth-management strategy could be suitable if:

- Your time horizon is multigenerational and spans decades.
- You need above-average rates of return.

- Income and capital gains taxes are a concern.
- Spending should be controlled.
- You want to implement complex tax, estate and philanthropic strategies.

Now that you know the wealth-management strategy that will fit your goals, choose from among the following five approaches to wealth-management planning:

- Maintain your purchasing power.
- Maintain a stable income.
- Conserve real wealth and your purchasing power.
- Retain real per-capita wealth across generations.
- Keep growing your wealth.

Regardless of which approach you use, you must be aware of two factors that can affect your outcome: leakages and growth.

Leakages can consist of taxes, fees and expenses associated with wealth management. Inflation is another leakage which you have no control over. Growth includes the ability to generate above-average returns. However, if you only focus on one of the factors, it doesn't work. For instance, if you think about how to get higher returns but don't consider the impact of tax efficiency or expenses, you'll end up with less in your pocket than you had expected.

Making It Work for Your Family

Each family member will have different views of money, and is at a different stage of life with plans that don't align with other family members. By developing a unified family strategy around asset growth and leakage prevention, you, as the Wealth Strategist, can reinforce common bonds and values across generations, which, in turn, will contribute to the long-term growth and preservation of your family's wealth. ●

The Three Worlds

To be an educated consumer, you must understand the three worlds of investment advisors. Each is inhabited by financial professionals ready to assist you with asset management. Nevertheless, no matter which you choose, always remember the first rule: buyer beware.

The Enchanted Forest

Wealth advisors in The Enchanted Forest use slick advertising, enthusiastic market predictions and expert commentary on the ever-changing nature of investing. They'll offer neophyte investors easy keys to prosperity.

This can make newly wealthy people, who are open to suggestions and vulnerable to persuasion, easy prey for advisors who overwhelm them with financial jargon and promises of quick market success.

Many of the advisors in The Enchanted Forest are hard-working professionals with winning personalities. They are usually competent and ethical, but sometimes not. In addition, their energy and creativity — rather than a track record of success — keeps clients coming back to these advisors for advice.

The Secret Society

In this world, inhabitants have learned how to consistently add value through good investment performance. They are driven investors and wealth advisors who aggressively seek new opportunities, yet they are modest and self-assured. They constantly look for what is wrong with their and other people's investment prospective and for ways to take advantage of those misperceptions.

This is not an easy world to enter since advisors who are in it shun publicity. Their strategies are highly confidential, customized and usually command high fees. Take caution though; there are a lot of imposters. When the advisors' luck runs out, the extra risk causes the investment to fall more violently.

The Capital Kibbutz

This is a world in which everyone who participates shares in the rewards and risks of the investment together. Here, you don't need to worry about which securities are cheap or expensive, and you don't buy or sell much. Generally you just let the economy work for you.

The Capital Kibbutz is the world of indexed mutual funds, exchange traded funds and term life insurance. The costs of market participation are quite low, allowing you to sleep well at night and pursue interests other than investing.

You won't earn the returns one experiences in The Secret Society, but so long as the economy performs relatively well, the average investor earns a better return than in The Enchanted Forest. ●

Picking Your Investment Strategy

Picking an investment strategy then sticking with it through market ups and downs is the single most important financial decision you will make. The following are three options, each with its own merits.

Index Investing

Indexing is the act of investing in a total financial market (i.e., the U.S. stock market, international stocks or the U.S. bond market) rather than trying to select specific securities. Studies have concluded that if you index, you are likely to end up with more money in your pocket than most people who choose more aggressive and time-consuming strategies.

So why don't wealth advisors push the indexing approach? There are four reasons:

- It is less profitable than actively managed funds.
- It sets a tough performance standard for active managers to beat.
- The low fees give firms less money to spend on marketing campaigns.
- It gives an advisor nothing interesting to talk about.

Barbell Investing

Picture a barbell with the weight on one side representing the management of your financial assets, probably using the Indexing Investing strategy. The counterweight is the energy and capital you have invested in your career or business. Connecting the two weights is sound, cash-flow management.

This type of investing is best if you are still working and not an investment expert. And as you build your career or business, your financial assets keep growing without a drag from spending. As a result, you can take modestly greater risks, earn more from those investments and enjoy more discretionary income in the future.

However, if you were to take a greater entrepreneurial risk and the business fails, you can rest assured that your financial assets will be there when you really need them.

The Active Alpha Investing Strategy

Active Alpha Investing involves integrating a diversified portfolio of traditional securities, for instance stocks and bonds, with exciting, high-return potential alternative investments, such as private equity, commodities and hedge funds.

People who employ this strategy are trying to get into The Secret Society. However, the majority of Active Alpha investors who succeed in their endeavors will beat the returns of Index Investing investors by only a small margin. Yet they will put enormous amounts of work into it.

Nevertheless, if executed well, an Active Alpha

Investment strategy has the long-term potential to generate a 10 percent to 15 percent annualized return in a variety of market and economic circumstances. ●

Making Your Most Important Hire

A Financial Administrator (FA) will partner with you to meet or exceed your financial goals using the investment strategy that you have chosen. The FA's role is clearly separate from that of the people who manage your investment portfolio. You want someone who is conscientious, of strong character, of high integrity, accountable to you and able to strike a balance between your interests and their employer's interests.

Regardless of which investing strategy you choose, you need an FA with in-depth experience and expertise in the following: managing financial performance, managing financial records, coordinating and recommending specialists, asset allocation and selecting investment managers.

Build a list of six or eight firms that you think can meet your needs. Include big brokerage firms, mutual-fund companies, banks and independent fee-only financial planners. Then prepare a written Request-For-Proposal (RFP). The following is a partial list of what you should include in your RFP:

- The firm's annual report.
- A brochure describing services and products offered.
- The firm's private client group organizational chart.
- An explanation of asset-allocation decisions.
- An explanation of how the firm chooses managers.
- A sample of a typical client-reporting package.
- The firm's fee structure.
- A minimum of five client references.

Can You Do It Yourself?

If you use the Index Investing Strategy, your family and financial circumstances are fairly simple, and you have the time and desire — yes, then you can. You could use firms like Vanguard that have a wide range of index investment products with the ability to track aggregate investment performance. And companies, such as Morningstar, have services that allow you to measure the individual and aggregate performance of all your mutual funds. Although acting as your own FA can be time-consuming, it can be rewarding and inexpensive with the right tools and dedication. ●

Taxes Can Be Your Ally

Taxes rank as either No. 1 or No. 2 on the list of expenses for the wealthiest Americans. And stopping this leakage should be a critical element in your investment strategy. Yet most investment managers don't concern themselves much with tax minimization because doing so doesn't reap them any bottom-line benefits. Therefore, you need to assume the responsibility to evaluate the after-tax performance of your investments in order to make taxes your ally in the wealth-management planning process and keep an eye on the big picture of tax minimization and efficiency.

You may have always thought that the IRS was an adversary. Consider these three points and you might change your mind:

- The government allows each taxpayer to apply the code's rules to his or her own advantage. This means that our actions and decisions impact our tax liabilities.
- The tax authorities don't make any money unless you do.
- The government provides services, such as defense, social security and roads in exchange for taxing you.

The tax code offers strong incentives for investors to think and act long-term. The top short-term capital gains tax rate is 35 percent. So if you sell an investment within one year or less from the day you bought it, you are taxed at this rate. However, today's top long-term capital gains tax rate is 15 percent — a full 57 percent lower, and you don't pay the tax until you sell. Deferred capital-gains taxes are like interest-free loans.

Improve Investment Results Through Tax Management

You can add to your portfolio's value by managing your taxes well. First, hire only a few broadly diversified, tax-efficient managers. Tax-efficient managers will hold winning investments longer, thereby allowing you to accumulate accrued taxes and share the investment risk with the government.

Next, start saving for retirement as soon as possible, even if it is 40 or 50 years in the future. This will help you make the most of the world of compounding. And if your tax rate is high, take advantage of IRAs, Roth IRAs or 401(k) plans.

Finally, be aware that high management fees and low returns are a bad combination. When this happens, you suffer doubly because your taxes are calculated before subtracting fees.

Avoid tax-deferred vehicles. Insurance companies sell

tax-deferred vehicles, such as variable annuities and life insurance savings plans as a way to postpone taxes until you withdraw money. However, even a modest hike in income tax rates can eliminate the benefits such products offer. On top of that, many of these structures have high administrative and investment fees that hack away at your investment's return. ●

Promoting Entrepreneurial Stewardship

Entrepreneurial stewardship involves striking the right balance of the following three areas to ensure your family can deal successfully with threats to its prosperity and harmony:

- Taking investment risks when good opportunities avail themselves.
- Preparing the next generation for the responsibilities of wealth management.
- Assuming strong family leadership.

One of the best ways to address the challenges of entrepreneurial stewardship is to combine a culture of openness with the opportunity for individual family members to opt out of family wealth-management activities. Then you are giving them a choice between sharing the benefits of commingled management of their assets on the terms offered or the option of acting independently. ●

Making Philanthropy Part Of Your Strategic Wealth Program

Philanthropic pursuits and public service can become a family's primary area of focus and thus tie a family together.

There are various ways to structure your gifts, depending how much control you want over the gifts and your desire to remain anonymous. The options include:

- Direct donations to 501(c)(3) organizations.
- Gifts to support organizations that have endowments to support an institution, such as an educational or a religious organization.
- Donations to donor-advised funds available through Fidelity, Vanguard and other financial institutions.
- Charitable lead trusts.
- Charitable remainder trusts.
- Private foundations.

Money, however, is not the only asset you can give. You will become a better philanthropist by getting directly involved in working with non-profit organizations. This is a chance to use your business skills and be confident that the organizations to whom you donate use the money well, and you will find it gratifying. ●

Multigenerational Planning And Wealth Transfer

You want to avoid estate plans that involve rigid legal structures, administrative overload, inadequately defensible positions if confronted by the IRS and whopping legal bills. Keep it simple and focus on three fundamental points: ensure that core needs of each generation are met, reinforce family harmony and empower subsequent generations.

Rather than thinking about “how much” to leave your children, you should be thinking about “how” you will leave it to them.

Primary homes and secondary/vacation homes can be integral to a family's traditions, but costly to maintain. As a family grows, there will be varying degrees of interest in these family assets and differing desires or abilities to manage them. Also there might be the urge by your children to sell a highly appreciated piece of property. Various legal techniques exist that can transfer real estate to your children.

However, before you do that, prepare a written operating agreement that spells out how they will handle the expenses, operations, scheduling and potential sale.

Intergenerational family lending is also one of the best estate-planning techniques around. For instance, an intergenerational, leveraged buyout freezes the value of a company for one generation and allocates any additional value to the next one. Another example would be a new business venture started with funds loaned to a child.

Prepare Estate Plans to Create Income Streams

You can create income streams for your children and grandchildren to tap immediately after your death or years thereafter. Or you can set up a plan that will kick in when the beneficiary reaches a certain age or milestone. Maybe you need to create an income stream to protect the financial security of someone who cannot fend for him or herself.

Retirement plans, such as IRAs and 401(k) plans, allow

you to name direct beneficiaries. Irrevocable trusts, however, offer a more effective way to pass assets to future generations. Since a trustee manages the trust's affairs according to the law and terms you established, the assets within the trust are protected from creditor claims, including bankruptcy lawsuits, divorce and liens.

Family companies and family partnerships are additional structures people use to transfer wealth and create income streams for beneficiaries. In many cases, they are designed to limit the liability of some or all participants. And unlike irrevocable trusts, the governing documents can be modified to suit changing circumstances.

Complex estate-transfer plans can be hard or impossible to change after they are put in place. Therefore, it will be worth the money to hire someone who is very knowledgeable, not only about estate law, but who also understands family dynamics and can advise you on how to administer an estate for many decades — regardless of the structures you set up.

Must-Dos

There are certain things you must do. Otherwise you will undermine everything you've accomplished in your wealth building.

- Write a will that clearly states your intentions for disposing assets not included in a trust.
- Set up a revocable trust to keep most of your assets out of probate.
- Set up a marital trust to protect your spouse's security while allowing you to have control over the eventual distribution of the assets.
- Consider giving assets to your spouse if you control most of your family's combined assets.
- Consider irrevocable trusts to provide for your children after you die.

Creating and Maintaining a Legacy

As the final leg of wealth management, estate planning should focus on three fundamental issues. First, is the assurance that you can live the rest of your life feeling financially secure and knowing that your heirs will have that same financial security. Second, is setting up an estate plan to prevent or minimize friction that can often undermine well-intended financial plans. Finally, the third component is realizing that you can transfer your wealth in such a way as to motivate and empower your heirs to aspire and succeed. ●

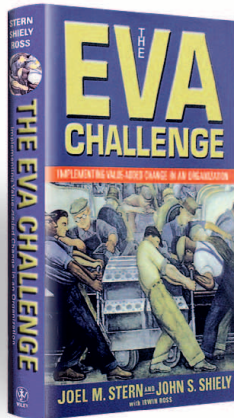
· Book 36 of 44 ·

The EVA Challenge

Joel M. Stern and John S. Shiely

SOUNDVIEW Executive Book Summaries®

FILE: FINANCE/ACCOUNTING



By Joel M. Stern and
John S. Shiely

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THE EVA CHALLENGE

THE SUMMARY IN BRIEF

What is a company worth? Another way to pose the question: What is the expected return on capital invested in one company as opposed to the return on capital invested elsewhere (at the same level of risk)? The calculation is not a simple one. The reason is two major developments in American capitalism: 1) the split between ownership and control of publicly held corporations and 2) the widespread acceptance of accounting measurements to gauge corporate value — a use for which accounting measurements were not designed.

Economic Value Added (EVA) is a measure of the true economic performance of a company — as well as a strategy for creating shareholder wealth. It is also a method of changing corporate priorities and behavior, right down to the shop floor. Properly implemented, EVA frees the measurement of corporate performance from the vagaries of accounting principles and aligns the interests of managers with those of shareholders, ending a decades-long conflict of interest.

What You'll Learn In This Summary

- **Standard accounting measures don't give the true picture.** They distort what is really happening and allow manipulation of the profit picture.
- **EVA is the answer.** Economic Value Added (EVA) is the profit that remains after deducting the cost of the capital invested to generate that profit. By adopting EVA, companies give everyone a clearer picture of the value being created by a company.
- **EVA is more than a measurement system.** EVA should be the foundation of a performance-based incentive plan.
- **EVA works in the New Economy.** New Economy businesses make heavy capital investments without immediate profitability. EVA gives such companies a way to measure the value they are creating.

THE EVA CHALLENGE

by Joel M. Stern and John S. Shiely

— THE COMPLETE SUMMARY

The Problem: Accounting Distorts Actual Value

Today's corporations are professionally managed; the true owners of the corporation — the shareholders — are divorced from the actual operations and control of the enterprise. In an attempt to monitor their companies' performance, shareholders use presumably objective criteria — the ones accountants use. Specifically, they look at the company's net earnings as reflected in earnings per share. As EPS grows, a company's share price is supposed to rise, on the assumption that its price/earnings ratio will remain relatively constant.

Misleading Assumptions

The problem is that as accountants work their way to the bottom line, they make several calculations on a company's profit-and-loss statement that distort economic reality. Specifically, as accountants prepare profit-and-loss statements, they make assumptions that undervalue the company's true economic value.

First, the "expense" (deduct from revenue in the year costs are incurred) research and development outlays. This has the effect of lowering profitability in the year the costs are "expensed" even though the benefits of R&D activities will impact the company's profits for years to come.

Accountants also "expense" advertising and marketing costs in the year they are incurred, even though the effect of those ads may be to build a brand that will pay dividends for years to come.

Finally, accountants list assets at the lower of original cost minus depreciation, or market value. For example, a building that cost \$10 million may now be worth \$20 million, but will be listed on the balance sheet as \$9 million (purchase price minus depreciation).

Manipulating EPS

In addition to accounting practices that distort reality, earnings per share can be easily manipulated, especially by senior executives whose bonuses may be tied to earnings improvements. One of many ways, for example, is to cut back on advertising and R&D, and thus lower costs and raise apparent profits.

In sum, as a result of standard accounting practices or even outright manipulation of the numbers, earnings per

share don't really present the whole picture for the investor who simply wants to compare the cash he can take out of the company with the cash he invested. ■

For another example of how EPS can be manipulated, go to: <http://my.summary.com>

The Solution Is EVA

Properly implemented, *Economic Value Added* (EVA) aligns the interests of the shareholders with those of the managers, ending the inherent conflict of interest that has long plagued corporations. EVA lets this happen because the measurement of corporate performance is no longer affected by the caprice of accounting conventions or the manipulation of managers looking for a larger bonus. Real economic profit is now the measure of corporate performance.

Already, more than 300 companies worldwide have adopted EVA, including Coca-Cola, Siemens, and the U.S. Postal Service.

The EVA Formula

What exactly is EVA? EVA is simply the profit that remains **after deducting the cost of the capital invested to generate that profit.**

For example, a new company starts off with \$5,000 borrowed at a 12 percent interest rate. In this case, the cost of the company's capital, known as the *capital charge*, is \$600 (12 percent of \$5,000). If the company makes a profit of \$1,000, the \$600 capital charge is deducted and the result is an EVA of \$400.

Thus, the exact formula for calculating EVA is net

(continued on page 3)

The authors: Joel M. Stern is a managing partner of Stern Stewart & Co., which developed the EVA concept. John S. Shiely is president of Briggs & Stratton, one of the earliest and most successful implementers of EVA.

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The Solution Is EVA

(continued from page 2)

operating profit after tax (NOPAT) minus capital charge.

Calculating the Capital Charge

To calculate the capital charge part of the EVA equation, you must first determine your company's *cost of capital*, often referred to as the required rate of return. This is the rate that compensates investors for their perceived risk, and varies from industry to industry. If the company's profits equal the required rate of return, the investor hasn't made money.

To calculate your company's cost of capital, you have to take into account both the cost of *debt* capital and the cost of *equity* capital.

The cost of debt capital is simply the interest on the company's borrowing. Since interest is tax-deductible, the after-tax rate is used.

Calculating the cost of equity capital is a bit more complicated. Equity capital starts with the interest an investor could earn on a safe investment such as a long-term government bond. You then add the equity risk premium — the percent of risk associated with investment in your company or industry.

After the cost of equity capital and the cost of debt capital has been calculated, you can calculate your company's blended cost of capital. This is achieved by determining the proportion of debt and equity capital in its capital structure. In 2000, the typical blended cost of capital (based on 2000 interest rates) came in between 10 percent and 13 percent.

Once you have the blended cost of capital, you can calculate the capital charge that is to be deducted from your company's profit. The capital charge is your company's total capital multiplied by its cost (in the example above, we had a \$5,000 total capital multiplied by the 12 percent cost to give us a capital charge of \$600).

Calculating NOPAT

Now you must calculate NOPAT. You will have to make adjustments for those accounting anomalies discussed earlier. There are more than 120 possible adjustments, but most companies will adjust just the following costs ordinarily expensed by accountants:

1. Research and development costs. These are considered investments that will yield future results. Under EVA, R&D costs are included on the balance sheet and amortized over the years these outlays are expected to have an impact. Only the yearly amortization charge is included as an expense.

2. Advertising and promotion costs. These are investments in trademarks and product recognition. Only

The Other Value-Added Measure

Along with EVA, another measure captures the gains or losses accruing to a company's shareholders. This measure is called Market Value Added (MVA) and is defined as the difference between the market value of a company and the sums invested in it over the years. It works like this:

✓ **Present Market Value** = equity at market price + debt at book value.

✓ **Total Investment** = equity + interest bearing debt (including retained earnings).

If Present Market Value is greater than Total Investment, then the company has created wealth. If it is less, it has destroyed wealth.

There is a significant link between EVA growth and growth in MVA. Rising EVA tends to foreshadow increases in MVA.

a portion of the cost is an expense in the current year.

3. Staff training and development. These costs are also an investment, and only a portion is expensed in the current year.

4. Depreciation costs. EVA allows depreciation to be subtracted in the current year, but only straight depreciation. Using accelerated depreciation creates an unrealistic view. ■

EVA Is More Than A Measurement System

EVA is far more than just a measurement tool. EVA should become the basis of an incentive plan that rewards managers for actions that increase shareholder returns — and penalize them for failure.

Specifically, companies should implement a plan that sets certain goals and timetables for EVA improvement. If a company, or a division in the case of a business unit manager, makes 100 percent of the targeted EVA improvement, the manager receives 100 percent of the "target bonus" promised. Lower results lead to proportionally lower bonuses. On the other hand, if the company or division does better than the target, then managers should receive a bonus in excess of the target bonus.

An EVA incentive plan can also feature a bonus "bank" — in which a portion (or all) of the bonus is banked to be distributed in later years, depending on ongoing performance.

The EVA bonus system usually begins with top managers, and eventually moves down to middle managers — and in some cases, all the way to the shop floor. ■

The Need for a Winning Strategy and Organization

The adoption of a fully articulated EVA program — a measurement program, a management system, and an incentive compensation plan, together with thorough training — is crucial to a corporation's success. However, EVA can't perform miracles. The organization must also have a winning strategy and an appropriate organization to carry out that strategy. A sophisticated EVA system won't help if the company's products lack a niche or other competitive advantage, if the company lacks a marketing plan, or if the company suffers from a dysfunctional organization.

EVA and Strategic Innovation: A Case Study

With \$1.3 billion in sales, Briggs & Stratton is the world's largest producer of air-cooled gasoline engines. The Milwaukee company was founded in 1908. Its engines propelled millions of lawn mowers as the post World War II population migrated to suburbia. It grew rapidly, employing more than 10,000 unionized workers by the mid-1980s. By then mass retailers like Home Depot and Wal-Mart insisted on getting the lowest possible price, and the company began running in the red. It was time for a dramatic change.

The company reevaluated its entire strategy and organization and adopted a full EVA program. It decided to concentrate on the low-end of the industry, where it had few competitors and where the entry barriers were high. For the first time in its history, the EVA discipline focused attention on the total cost of capital.

In 1989, [Briggs & Stratton] had a negative EVA of \$62 million. By 1999, it had a record positive EVA of \$50.9 million.

The company reorganized into seven separate operating divisions. Each division was given autonomy for operational decisions and capital expenditures. By pushing decision-making down, the company saw a dramatic improvement in cash flow and capital management. Divisional EVA results provided 40 percent of managers' bonuses. Now even hourly-rate workers have a modified form of EVA written into their union contracts.

It has worked very well. By reorganizing and focusing its strategy while developing its EVA program, the company has made a dramatic recovery. In 1989, the company had a **negative** EVA of \$62 million. By 1999, it had a record **positive** EVA of \$50.9 million. Anyone who bought \$100 worth of stock in 1989 would have had \$673 in 1999. ■

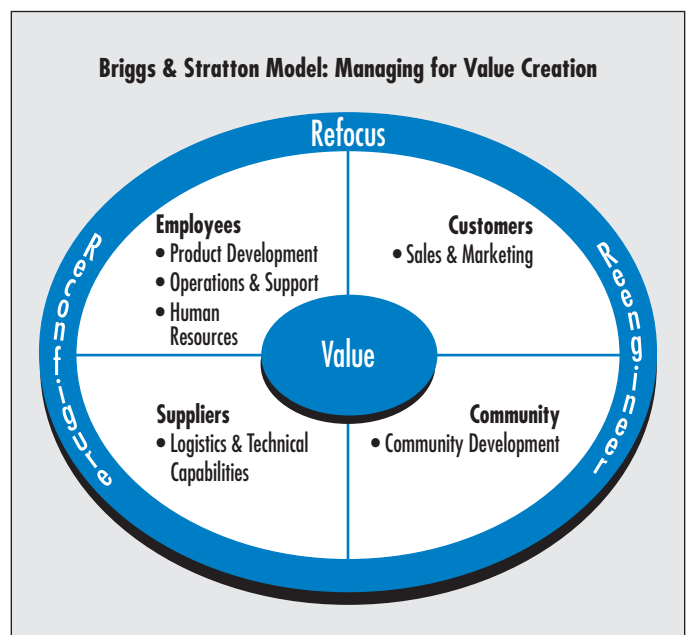
The Road Map To Value Creation

Today, companies struggle with the idea that they must create value for shareholders, employees, customers, suppliers and the communities in which the company is located. The traditional view that only the shareholders mattered, and that other stakeholders would benefit as long as the shareholders made a profit, is no longer accepted by many.

The interests of shareholders and other stakeholders are sometimes at odds. In the long run, however, their interests are mutual. A company cannot prosper over a long period of time if it antagonizes its work force, develops low-quality products, treats suppliers poorly or pollutes the environment.

The goal of top managers is to align shareholders' interests with those of the other stakeholders. How can value be increased for shareholders **and** stakeholders? One solution is to adopt the **holistic model of value creation** (see illustration below).

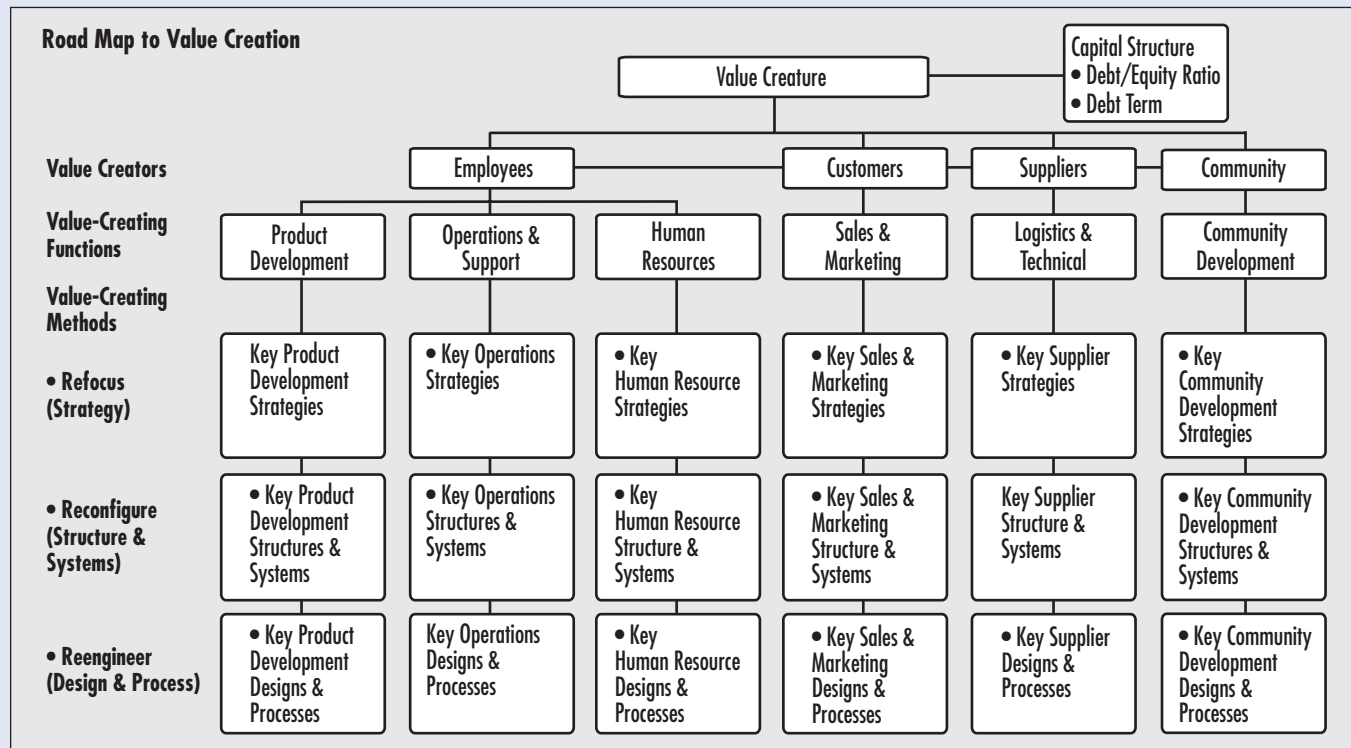
The functions associated with each group are set forth in the model. The most important functions are those that integrate employees into the value-creating process — new product development, operations and support, and human resource development. As you move across the model, you see that the function that drives customer value is sales and marketing while the key to value-adding supplier relationships are logistics and technical capabilities. Community development consists in working out cooperative agreements between local political entities and the company for their mutual benefit. ■



Creating a Road Map to Value Creation

Employees may understand the reasons for their company's success, and readily buy into the idea of EVA, but sometimes wish management would clearly communicate to them the company's *vision* of value creation. To communicate the strategy, companies can create a one-page "Road Map to Value Creation."

By viewing the model vertically, each employee can see how the firm intends to create value in his or her primary functional area. For each function, the map describes the underlying strategy, the supporting structures and systems, and the key designs and processes. By viewing the model horizontally, employees can see how the company's strategies, structures and systems, and designs and processes are integrated along functional lines.



The Dramatic Results of EVA

The implementation of an EVA program can impact both the top-level strategy of a company as well as day-to-day management decisions, as demonstrated by the case studies in this article.

Phantom Profits at International Multifoods

The turnaround of International Multifoods, a diversified food company based in Wayzata, Minn., illustrates the effectiveness of applying EVA guidelines to strategic planning.

When new CEO Gary Costley was installed in January 1997, he declared that "the company was a mess." Costley, who had worked for the Kellogg cereal company before becoming a business school dean, concluded that International Multifoods had bounced from strategy to strategy without much thought. The company's activities had moved from milling wheat to manufacturing consumer goods to distributing other companies' food products to exporting chicken parts to Russia.

In addition to a rudderless strategy, the company's balance sheet was a disaster.

Before Costley took the job, he insisted that the board of directors authorize an EVA program.

One of the first areas to be examined was the Russian chicken business. The export of dark meat was the company's fastest growing contributor to operating profits. However, while the export of dark meat was profitable on an earnings per share basis, it was an economic disaster from an EVA point of view.

The business gobbled up working capital. Each boatload of chicken shipped from New Orleans sat on the company's balance sheet for six weeks until it was transported and sold. When the cost of capital tied up in drumsticks was deducted, the profits evaporated.

Based on its rigorous EVA evaluation, the company exited the chicken business and several other equally capital-eroding sidelines, such as shipping used tele-

(continued on page 6)

The Dramatic Results of EVA

(continued from page 5)

phone poles to Third World countries. Within two years, the company was recovering and its share price doubled.

Store-Level EVA at JD Group

South Africa's JD Group, a chain of more than 500 furniture, appliance and consumer electronic stores also experienced great results from the implementation of EVA. The company took EVA down to the store level by measuring the EVA performance of each branch, and rewarding managers accordingly. Because it now mattered, branch managers no longer routinely replaced delivery trucks, but refurbished the ones they had. They stopped completely revamping stores and voted instead to spruce them up with fresh paint.

Analyzing Capital Expenditures at Herman Miller

EVA doesn't always mean that capital expenditures are rejected, however. Instead, those who understand EVA well analyze each expenditure to see whether it contributes to value creation or not.

For example, when one division of Herman Miller, the office furniture manufacturer, debated whether to repair a piece of equipment or buy a new one, they considered factors such as reliability and the effect downtime has on production. In one case, they opted to replace a piece that could have been refurbished at lower cost, but which would not be 100 percent reliable. The component would halt the entire line while down. On the other hand, they refurbished a stand-alone piece because it would have no effect on the production line while it was down. ■

Extending EVA To the Shop Floor

Bringing EVA to the shop floor isn't always easy. This has been especially true in work environments that have been unionized.

Briggs & Stratton ran into just such a problem during its implementation of EVA. Management asked the union to negotiate the next contract early because it intended to restructure operations and create new "focus factories," each devoted to a single product. The intent was to make operations more efficient, and thus the company more competitive.

The union viewed the plan with suspicion, refused to negotiate early, and staged an expensive work slowdown. But the company persisted, and opened four focus factories in other states. Meanwhile, distressed at

Briggs & Stratton Workers Innovate to Raise EVA

When workers on the shop floor buy into EVA, the savings they can achieve are remarkable. Here are two examples of what workers at Briggs & Stratton have been able to achieve.

A group of workers was formed to reduce the cost of making tappets — the sliding rods in engines. The group discovered that the problem was the thickness of the wire used to produce the rods. It took too long to heat the metal. The solution they conceived was to use thinner wire. It worked, and saved more than \$220,000 annually.

Another group took on the task of reducing the changeover time needed to ready a metal stamping press to handle a new job. When the team started on the problem, it took two workers 22 hours to make the changes. After moving the press to a better location and making other changes to the process, the time was reduced to less than two hours, for an annual savings of \$64,000.

the loss of jobs, the union opened negotiations.

The contract eventually adopted calls for an EVA measurement as a variable component of shop workers' pay. Workers receive 3% bonuses if the company makes its EVA target. The bonuses can reach even higher, depending on how much value is built in a given year.

Communicate Directly With Your Work Force

Clearly, it can be difficult to persuade workers accustomed to antagonistic labor-management relationships that everyone will benefit from implementation of an EVA plan.

Union leaders have traditionally been instilled with the belief that "fair" means "equal" and that all performance-based compensation should be viewed with suspicion. How, then, can you negotiate an EVA-based compensation program — an incentive system that relies on sophisticated microeconomic principles — into an agreement with an organized work force?

One important step is for management to communicate directly with its work force. Winning over the rank and file is the key. Though you can't directly discuss wages and benefits, you can certainly discuss EVA as a performance metric and train workers in the basics of EVA. And you can certainly explain that a positive EVA is essential to the continued viability of the company.

Take the time to explain to workers what you have decided to do to create value. Describe your operational model, and give all employees an opportunity to refine

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Extending EVA to the Shop Floor

(continued from page 6)

it through suggestion programs and business improvement teams. If a successful effort has been made to reach the rank and file, it will be easier to persuade the union leadership to adopt EVA as a basis for incentive compensation. ■

Getting the Message Out: Training and Communication

There is no more important aspect of installing an EVA program than training the troops. EVA represents a decisive change in every aspect of how a company conducts its business. With the focus on improving EVA as the new bottom line, traditional practices will be altered, from incentive systems to the allocation of capital to production processes on the shop floor. Change — often drastic change — is the name of the game, and it is rarely popular. To those in the trenches, the new and unfamiliar seem threatening. Fear prompts resistance.

But if employees are given a clear, detailed description of changes and the reasons for them, a good deal of anxiety can be erased. They need to be told why EVA is necessary. Workers who know the new program is necessary for the long-term survival of the company are more likely to support it.

Three Years of Training

At Briggs & Stratton, training took three years and involved more than 3,000 workers. In groups of 16 to

20, salaried workers received four hours of training in “Managing for Value Creation.” Production workers received two hours of similar training.

Each session started with a written test on what each worker knew about EVA. The test was followed by a description of the company’s strategic restructuring. The instructor highlighted the company’s reversion to a low-cost, high-volume producer of multi-purpose engines. This was followed by a detailed explanation of the company’s “Road Map to Value Creation,” which directly shows how the company’s design and processes, structure and systems and strategy help value creators (not only employees, but also suppliers and customers) create value. The instructor also showed how EVA is calculated.

The discussions that followed stressed three fundamental ways to enlarge EVA: (1) “build” it by committing new capital to initiatives that promise a return in excess of the cost of capital; (2) “operate” in a way that increases the cash rate of return without tying up new capital; and (3) “harvest” by withdrawing capital from strategies that aren’t expected to provide an adequate return.

The participants then practiced finding ways to increase EVA through a hypothetical business case study, and were finally asked for ideas for increasing EVA for their own company. ■

EVA and Acquisitions

Much of the history of American capitalism is the history of mergers and acquisitions. First, a new industry emerges with many players. Then winnowing occurs — a process of consolidation through failure and the absorption of the weak by the stronger, better financed, and more aggressive competitors. In times past, the goal of consolidation was to create a monopoly, with obvious benefit to shareholder value.

Today, monopoly power is beyond the aspiration of most companies. In its place, the motivation for consolidation is the creation of additional value for the acquiring company. EVA valuation is an excellent tool for calculating the impact of a proposed acquisition. It does not, however, provide the nonfinancial criteria for evaluating the wisdom of an acquisition.

Do Your Homework

Acquisition is still a viable option for creating additional value, but only if the acquiring company does its homework. Before identifying a target, focus on your own corporate skills, competitive strengths, and strategic aspirations. Next, create a set of criteria to define the universe of candidates. Your company must be able to identify any lurking problems, such as pending litigation.

Continual Communication Keeps EVA Alive

At Herman Miller, training in EVA didn’t end with the initial sessions. Every month the company produces a 15- to 30-minute video called the *Business Exchange*. It features a full report on how the company is doing, from net sales to the month’s EVA.

The rest of the video is devoted to other corporate news, such as prizes won by the company at trade shows and charitable activities taken on by employees. Every month, the videos are viewed by all employees with their supervisors. For those who want more information, it is available on the company’s intranet. Workers can view the information from their computers. Those who don’t have one at work can access the same information from computer kiosks set up on the shop floor.

(continued on page 8)

Identifying Acquisition Targets

When looking for acquisitions that have a high potential for increasing value, consider companies in this order of preference:

1. Companies with comparable product lines. The greatest potential for integrating efficiencies is in acquisitions of companies with comparable product lines. If that's the case, the acquirer can quickly realize economies of scale, distribution and product development.

2. Companies producing related product lines. Next in line for consideration are companies that produce related products. For example, a producer of golf course mowers might acquire a company that makes golf course irrigation equipment to leverage its knowledge of the turf-care business and its established relationships with greens keepers to create value.

3. Companies that make linked products. Next consider the acquisition of a company making linked products — products that exist in totally unrelated businesses but are somehow linked in terms of technology, production or distribution. For example, a company producing commercial aviation equipment might acquire a company making auto global positioning units, and apply the technology to aviation.

4. Companies that make unrelated products. It's unlikely such an acquisition will create value. Proceed with care.

EVA and Acquisitions

(continued from page 7)

tion, environmental concerns, or other hidden liabilities.

There are two parameters that help predict whether an acquisition will have a positive effect on EVA once the companies are one. The first is whether the target company has products that are in the company's existing product base. If so, it will be much easier to integrate the company and create additional value through operational synergies. The second parameter is the nature of the potential integrating efficiencies. For example, if two companies can consolidate production facilities, there is great opportunity for cutting production costs and therefore creating more value. ■

For information on why conglomerates fail to create value, go to: <http://my.summary.com>

How EVA Can Fail

Sometimes companies try to adopt EVA, but fail. When that happens, the reason is almost always that

there was either a lack of full support or the appearance of a lack of support for the program by the company's chief executive. Without question, the attitude of the chief executive is the primary determinant of the success or failure of the program. EVA is such a radical departure from the traditional way of measuring success and motivating people that it requires unremitting pressure from the top to assure compliance.

Don't Even Try It!

There are also circumstances in which moving to EVA will fail and shouldn't even be tried.

For example, if the top executives are overpaid for poor performance so that it would be likely they would receive far less under EVA, it won't work. The same thing happens if the talent in the company pool is mediocre. If so, EVA incentives won't work because the talent just isn't there in the first place and the goals set under EVA are unattainable.

EVA will also have trouble working in an environment where jobs are secure and promotions come from seniority. Employees in such companies prize an unstressed work environment and can't or won't change. ■

For another example of an environment unconducive to EVA, go to: <http://my.summary.com>

EVA in the New Economy

We are in the midst of a new era heralded by many as the knowledge revolution. There are some who have proclaimed that this so-called new economy means the death of EVA. They claim EVA is useful for old world companies with heavy investments in fixed assets, but that today there is no need to worry about capital charges.

They are wrong. There may be a new economy with products and services available in revolutionary ways, but there are no new "economics." The principles of economic valuation remain the same.

EVA analysis is particularly appropriate for some new economy businesses that are investing heavily in infrastructure now for an anticipated profit later.

EVA treats cash outlays that represent investments as capital rather than expenses. It tells us what contributions are being made to value each year. The capital in the new economy consists of research, development, marketing, advertising and start-up costs. Accountants view these expenditures as expenses to offset against current profits. But it is more realistic to capitalize these investments and amortize them over their expected useful life, as EVA does. ■

· Book 37 of 44 ·

The Holy Grail of Investing

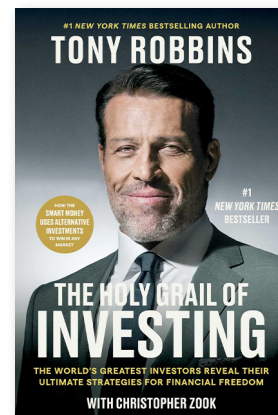
Tony Robbins

Executive Book Summaries®

The Holy Grail of Investing

The World's Greatest Investors Reveal Their Ultimate Strategies for Financial Freedom

by **Tony Robbins with Christopher Zook**



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THE SUMMARY IN BRIEF

The key to wealth-building is investing in alternative investments, which are typically restricted to high-net-worth individuals. These investments include stakes in private equity firms, sports teams, real estate, and venture capital, and can outperform traditional investments and reduce risk. Furthermore, the world's most successful investors focus on diversification and avoiding big losses.

In *The Holy Grail of Investing: The World's Greatest Investors Reveal Their Ultimate Strategies for Financial Freedom*, renowned motivational speaker and author Tony Robbins, along with Christopher Zook, highlight the benefits of these options and provides guidance on how to access them.

IN THIS SUMMARY, YOU WILL LEARN:

- Why the best way to build wealth is to invest in a variety of “alternative investments” not typically accessible to most investors.
- What these alternative investments include, such as stakes in private equity firms, sports teams, and real estate, among others.
- The benefits of these alternative investments and how to access them.
- Key details about successful investors who share their insights on how to win in the investment game.

Immutable Laws of Investing

Although the titans interviewed for this book shared very different approaches to investing, they all agreed on certain immutable laws and steps the investor needs to take, and avoid, to win the game.

First, don't lose. One thing that all the most successful investors have in common is they know that they will indeed lose at times. To mitigate this, they never get too far over their skis and risk too much on any one investment.

Second is the core principle of asset allocation—i.e., spreading your assets among different types of investments with varying risk-reward ratios.

Third, wherever possible, look for opportunities with “asymmetric” risk reward. They look for investments where the potential reward far exceeds the downside risk.

Fourth is the principle of diversification. You want to own a wide variety of investment types.

It is undeniable that smart money uses high-quality alternative investments as the engine for greater diversification and accelerated growth. This is what the titans of finance do with their own personal capital.

For this book, some of the most successful alternative investment managers have been interviewed. These investors have shown that while they're not immune to the ups and downs of the economy, they know how to thrive, not just survive, during the economic winters. Instead of being content to ride out the storm, they go shopping when prices are down.

Many of today's traditional investments are “correlated,” which simply means they move up or down in unison.

The problem is that today most traditional diversification strategies tend to involve adding more and more positively correlated investments! Some investors seem to have given up on finding uncorrelated investments to help manage big swings.

So what is the “Holy Grail” of investing? According to Ray Dalio, the founder of Bridgewater, the Holy Grail is a portfolio of eight to twelve uncorrelated investments which, together, will dramatically reduce risk without sacrificing returns.

Dalio demonstrates that a portfolio structured this way can reduce risk by as much as 80 percent while maintaining the same, or similar, upside potential. There's one big chal-

lenge: Where do we gain access to so many high-quality noncorrelated investments? Turns out, access is the tricky part—and that's precisely what this book is about.

Once you reach a certain net worth, the SEC invites you into a special special club. They deem you an accredited investor when you achieve \$200k in annual income or \$1 million net worth. The SEC bumps you up to qualified purchaser status when you have \$5 million in total investments. This opens up the entire universe of alternative investments. But here's the rub...just because you qualify, doesn't mean you can get in the door.

It bears repeating that our asset allocation, how much we choose to invest and in which asset class, is the greatest driver to our investing success.

Ultra-high-net-worth families (those with over \$30 million) have nearly 46 percent of their assets in alternative investments. Why? On a global level, private equity outperformed public markets in thirty-five of the last thirty-five years.

Private equity performs well in good times, but it has also weathered many a storm. A study by Wall Street behemoth Neuberger Berman summed it up nicely: “Private Equity historically experienced a less significant draw-down, and a quicker recovery, than public equities in all three downturns.”

This is not to say that public stocks don't have a role in our portfolios. Numerous studies have shown that adding private equity to a typical stock-and-bond portfolio has the tendency to not only reduce volatility, but also increase returns.

The good news is the House of Representatives has passed a bipartisan bill that will allow anyone, even if they fall short of the wealth requirements, to become an accredited investor if they pass a test.

Getting an “allocation” in a highly sought-after private equity fund is the wealthy person's version of getting past the velvet rope at a hot new nightclub. So, how can one participate in this seismic shift toward alternative investments?

Instead of fighting to get into a fund as an LP investor, a limited partner, there was sometimes a way in which one could join up and become an owner of the entity known as the GP, general partner. This world, known as “GP stakes,” has become increasingly popular among big institutional investors over the past decade but is only beginning to see mainstream coverage.

Over the past decade, major sports leagues have significantly outperformed traditional stock market indexes like the S&P 500.

Becoming a minority/passive owner in an asset management firm has three benefits:

1. Cash Flow
2. A Piece of the Profits
3. Diversification

This book provides seven unique uncorrelated investment opportunity strategies.

GP Stakes

When buying a stake in any type of business, we have to understand its revenue engine. How will the business make money? The GP is normally paid at least two distinct sources of revenue for their management services: Management Fee and Performance Fee. A GP stake will typically produce annual cash distributions in the range of 5 percent to 10 percent annually, beginning on day one of the investment.

Outside of the income stream paid to investors, it is true that GP stakes are generally considered illiquid. That said, there are ways to generate liquidity should you want to sell your position.

1. Certain vehicles will periodically provide a “tender offer” for your ownership position.
2. You will likely be able to sell your positions in a “secondary” transaction depending on the quality of the asset.
3. Many firms are eventually acquired by other industry players, which creates a harvest event for all the owners of the business. This is often at a significant multiple on the business’s profits.
4. Some firms choose to go public, which provides owners of GP stakes with publicly traded stock.

Why in the world would a successful private equity firm, private credit firm, or any private asset manager sell a piece of their business?

The GP stake investor wins by owning a piece of a high-quality operating business, and the firm wins by bringing in much needed capital that will help accelerate the growth in enterprise value. Despite good reasons as to why an asset management firm might sell a piece, the world of GP stakes is relatively small.

Access to GP stakes in a business is generally limited to investors who have long-standing relationships with said firm, as the management teams are understandably cautious as to who they want as their minority partners.

Pro Sports Ownership

There have been relatively recent rule changes that have opened the door for very specific types of investment funds to buy a minority stake in not only one but numerous teams. Whether you are a sports fan or not, these global businesses have some unique characteristics that make them extremely attractive as part of one’s Holy Grail strategy.

Over the past decade, major sports leagues have significantly outperformed traditional stock market indexes like the S&P 500. These returns are particularly attractive because they’re achieved with minimal debt and show low correlation to the overall market, making them a valuable diversification tool for an investor’s portfolio.

Sports franchises are not only financially secure but also hedge against inflation. There are two revenue streams that contribute to this strength: league revenue and team revenue.

Traditionally, only very wealthy individuals could afford to own a team. Recently, Major League Baseball changed its rules to allow qualified investment funds to buy minority stakes. This allows individual investors to participate by investing in these funds which hold a diversified portfolio of teams across different leagues. Owning a share of a team can be a good investment due to diversification and potential tax benefits.

Private Credit

Private credit offers a compelling alternative to traditional bonds, especially in a high-inflation environment.

Private credit offers “substantially better rates of return” than bonds, even exceeding junk bond yields in 2021-2022.

Unlike bonds, private credit loans typically have floating rates that adjust with market rates, protecting investors from rising interest rates.

Private credit has experienced low default rates due to stricter underwriting standards and senior secured loan positions. Even in the worst five-year period, private credit still produced positive returns.

Energy

The term “energy transition” is a misnomer.

Throughout history, new energy sources have been “added” to the mix, not replacing older ones entirely. Coal, oil, and natural gas all took decades to reach significant market share.

Solar, wind and other renewables are a growing part of the energy mix, but they will never fully replace fossil fuels. The US Energy Information Administration predicts growth in all energy sources, including fossil fuels, to meet rising demand by 2050.

While a proponent of clean energy, Jamie Dimon, CEO of JPMorgan Chase, believes oil and gas will make up a significant portion of the energy mix for the next 10-20 years.

We must deliver the cleanest energy possible to as many people as possible to drive global economic growth and food security. And we must do so in a cost-effective way. Energy is notoriously volatile, so proceed with caution.

Venture Capital and Disruptive Technology

When it comes to venture capital, the disparity between the all-stars and “the rest” is extremely large. Between 2004 and 2016, the top 10 percent of venture capital firms generated returns of 34 percent annually.

The only route for most investors is to partner with firms who have existing relationships in place. Individuals, and their advisors, can leverage that buying power and long-standing relationships.

We are heading into the greatest acceleration of innovation in the history of humanity, and venture capitalists are the tip of the spear. They take massive risks, and sometimes they lose big. But when they win, they win big, all while funding the next generation of life-changing innovation.

Real Estate

Real estate is the undisputed behemoth of alternative investments and is the oldest and largest asset class. It is likely a part of most Holy Grail portfolios whether it be a residential home, investment properties, or both.

On the whole, and over many decades, real estate performance has generated conservative mid-single-digit to low-double-digit returns. But the use of leverage has allowed for substantially higher returns—coupled with substantially higher risk!

Real estate is also an asset class that, for U.S. investors, offers government-sanctioned tax avoidance. Tax-efficient income, potentially unlimited tax deferral, and tax avoidance of all capital gains upon death are precisely why many of the nation’s wealthiest families are real estate dynasties.

However, while hard assets can be incredibly valuable, they can also turn quickly when their price is extremely sensitive to interest rates.

In commercial real estate, there is a new dynamic of remote or hybrid work that has created what some experts are calling obsolescence risk. Commercial real estate buyers must ask themselves if the property they want to purchase is still viable. And beyond that, if it will be viable in ten years or fifteen years or twenty.

Other risks include AI, geographic/political, and interest rates. All things considered, a significant amount of commercial real estate seems headed for a cliff, but the residential real estate market is sending different signals.

In residential real estate, we have talking heads beating the “crash is coming” drum. And while prices are most certainly softening, the data seem to be telling a different story.

How do we know we aren’t in for another collapse? It always goes back to Economics 101: supply and demand.

With such low inventory currently, the market might surprise us with somewhat steady housing prices or even moderate growth in higher demand areas, particularly if mortgage rates come down from here. Bottom line: inves-

For those who like to buy things on sale, certain categories of real estate will become extremely attractive over the next few years.

tors proceed with caution.

In multifamily residential real estate, rents have been steadily rising for many years, making investors quite happy. That said, apartments are beginning to show signs of weakness in certain geographies, particularly where developers have overbuilt.

Meanwhile, a perfect storm of rising interest rates, falling rents, increased evictions, and rising insurance premiums and property taxes is brewing.

For those who like to buy things on sale, certain categories of real estate will become extremely attractive over the next few years. We anticipate major discounts in commercial and multifamily real estate as sellers are forced to unload their properties.

Buyers will need to pick their spots wisely and be able to answer the tough questions regarding viability. That said, experts believe that there will be severe dislocations in the market that will create tremendous buying opportunities that we have not seen in nearly two decades.

Secondaries

What happens when you are invested in something illiquid like private equity? How does one go about selling an illiquid investment? Enter the world of secondary transactions.

If an investor wants or needs to liquidate their position early, the only way they can achieve this is by selling their position to another interested investor who would simply take their spot. This is called an “LP-led secondary,” as it’s initiated by the limited partner.

In today’s world, finding another interested investor to whom you can sell your position is quite easy. The good news is, for the foreseeable future, we are going to be in a buyer’s market. There simply is not enough capital to buy the number of available secondaries. Thus, sellers will likely entertain higher discounts, and we can be more discriminating in picking only the highest quality holdings.

Next are some bios of the “masters of the financial universe.” These are some of the most brilliant minds in the world of private equity, private credit, real estate, venture capital, and beyond. Although past performance is no guarantee of the future, many of these men have generated compounded returns of north of 20 percent annually.

Masters of the Financial Universe

Robert F. Smith , Founder And CEO Of Vista Equity Partners

“So, a lot of my origin story has to do with people who excited my imagination. People who sparked my curiosity, gave me some freedom to explore, expand, make mistakes, and ask questions.”

Accolades: Listed by Forbes as one of the Top 100 Greatest Living Business Minds. Member of the philanthropic Giving Pledge. The wealthiest African American in the U.S. Total Asset Under Management as of August 2023: \$100 billion+

Highlights:

- Completed over six hundred private equity transactions, representing nearly \$300 billion in transaction value since inception.
- Vista’s ecosystem spans more than eighty companies with more than ninety thousand employees active in over 180 countries.
- Named as a Top Founder-Friendly Investor by Inc. magazine four years in a row.
- In 2017, Robert was named one of the 100 Greatest Living Business Minds by Forbes.
- Time magazine 100 Most Influential People 2020.

Vinod Khosla, Founder Of Khosla Ventures

“In forty years, I’ve never called myself a venture capitalist. I always say I’m a venture assistant. This idea that you work with the founders to help them realize their dreams is what I enjoy doing.”

Accolades: Turned a \$4 million investment in Juniper Networks into \$7 billion in profits. Early investor in Open AI. Member of the philanthropic Giving Pledge. Total Asset Under Management (as of August 2023): \$15 billion

Highlights:

- Vinod Khosla cofounded Sun Microsystems in 1982, which created the Java programming language, and was later acquired by Oracle for \$7.4 billion.
- Through his career, Mr. Khosla has been an early investor in Google, LinkedIn, Nest, DeepMind, Instacart, DoorDash, Impossible Foods, Affirm, among many others.
- Among his many honors, Mr. Khosla has been named as one of the top tech investors in 2023 by Forbes, the world's greenest billionaire, and has won the National Medal of Technology.

Michael B. Kim, Founder And Chairman Of MBK Partners

"In private equity, we create alpha. And the way we create alpha after buying a company is by rolling up our sleeves to do the hard work to create value."

Accolades: The Godfather of Asian Private Equity and wealthiest man in South Korea Total Asset Under Management (as of August 2023): \$25.6 billion

Highlights:

- MBK Partners is the largest private equity manager in North Asia, with \$25.6 billion in assets under management.
- Top-decile returns performance for every active fund—"The Most Consistently Top-Performing Buy-out Fund Manager(s)," 2019, by Institutional Investor.
- Michael B. Kim was ranked as one of "The 50 Most Influential People in the World" in 2015 by Bloomberg.

Ian Charles, Founder Of Arctos Sports Partners

"We have to constantly reinvest and reevaluate and be totally fine ripping something up and saying, 'That worked really two years ago but stop talking about that because it doesn't matter tomorrow.'"

Accolades: A pioneer in creating the industry's first sell-side advisor for private equity secondaries Total Asset Under Management (as of August 2023): \$6 billion

Highlights:

- Ian Charles cofounded Cogent Partners, the first secondary market sell-side advisory firm, which was later sold for \$100 million.
- Mr. Charles cofounded Arctos Partners, the first institutional platform to pursue a global multi-league, multi-franchise investment strategy.
- Arctos's debut fund was the largest first-time private equity fund ever raised at close to \$2.9 billion.

Bob Zorich, Cofounder Of EnCap Investments

"Our policies are directing our capital toward low-density answers and away from high-density solutions. The result will be a train wreck as we will find ourselves short of the energy required to fuel the world's energy demand."

Accolades: EnCap is one of the top 10 energy investors in the U.S. Zorich is a member of the Independent Petroleum Association of America and also serves on the board of several Houston charities.

Highlights:

- Zorich and his partners have successfully raised and managed \$40 billion across 24 funds.
- EnCap has backed over 275 startup energy companies.
- These teams used experience and focus to create billions of value for investors and were key instigators to the shale revolution.

The wisdom, strategies, and insights contained in this book can be foundational to your pursuit of financial freedom. However, a core truth is that knowledge is not power, it's potential power.

Execution trumps knowledge every day of the week. So, how will you build your Holy Grail portfolio? What steps can you immediately take on your journey to financial freedom? Start today using the contents of this book as a guide to your future.



Tony Robbins is an international entrepreneur, #1 New York Times bestselling author, and philanthropist. Robbins is a leader called upon by leaders: He's consulted and coached some of the world's greatest athletes, entertainers, Fortune 500 CEOs, and four US presidents. Christopher Zook has more than thirty years of experience investing in both traditional and alternative asset classes. He is a regular contributor to major media outlets, including CNBC, Fox Business, and Bloomberg. In 2019, Texas Governor Greg Abbott appointed Christopher to the State of Texas Pension Review Board, where he serves as chair of the Investments Committee.

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The New Paradigm



The New Paradigm for Financial Markets

The Credit Crisis of 2008 and What It Means

THE SUMMARY IN BRIEF

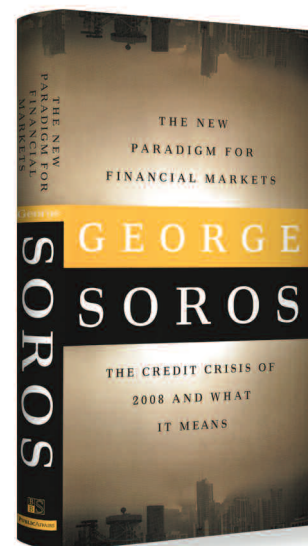
“This is the worst crisis since the Great Depression,” writes George Soros of the scale of financial distress spreading across financial centers around the world.

In the midst of the most serious financial upheaval in decades, legendary financier George Soros explores the origins of the crisis and its implications for the future. Soros, whose breadth of experience in financial markets is unrivaled, places the current crisis in the context of decades of study of how individuals and institutions handle the boom-and-bust cycles and dominate global economic activity. The prevailing paradigm for financial markets — that markets tend toward equilibrium and deviations from it are random — is both false and misleading, he argues, and only by exploring a new conceptual framework for how markets really work can we avoid disaster and economic ruin.

Combining practical insight with philosophical depth, Soros makes an invaluable contribution to our understanding of the great credit crisis and its implications for our nation and the global economy.

IN THIS SUMMARY, YOU WILL LEARN:

- How the financial crisis is wreaking havoc on the financial system and threatens to engulf the economy.
- Why the concepts of reflexivity and fallibility make an important contribution to our understanding of financial markets.
- Why reflexivity is best demonstrated and studied in the financial markets.
- How the theory of reflexivity applies to the unfolding financial crisis.
- Why the United States needs to gain a better understanding of the situation in which it finds itself today.



by George Soros

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THE COMPLETE SUMMARY: THE NEW PARADIGM FOR FINANCIAL MARKETS

by George Soros

The author: George Soros is chairman of Soros Fund Management and is the founder of a global network of foundations dedicated to supporting open societies. He is the author of several best-selling books including *The Bubble of American Supremacy*, *Underwriting Democracy* and *The Age of Fallibility*. He was born in Budapest and lives in New York City.

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For additional information on the author, go to <http://my.summary.com>.

Introduction

We are in the midst of the worst financial crisis since the 1930s. In some ways it resembles other crises that have occurred in the last 20 years, but there is a profound difference: The current crisis marks the end of an era of credit expansion based on the dollar as the international reserve currency. Other periodic crises were part of a larger boom-bust process; the current crisis is the culmination of a super-boom that has lasted for more than 25 years.

To understand what is going on we need a new paradigm. The currently prevailing paradigm, namely that financial markets tend toward equilibrium, is both false and misleading; our current troubles can be largely attributed to the fact that the international financial system has been developed on the basis of that paradigm.

A New Paradigm

The new paradigm proposed here is not confined to the financial markets. It deals with the relationship between thinking and reality, and it claims that misconceptions and misinterpretations play a major role in shaping the course of history.

Market participants cannot base their decisions on knowledge alone, and their biased perceptions have ways of influencing not only market prices but also the fundamentals that those prices are supposed to reflect. The participants' thinking plays a dual role. On the one hand, they seek to understand their situation: the cognitive function. On the other hand, they try to change the situation: the participating or manipulative function. The two functions work in opposite directions and, under certain circumstances, they can interfere with each other. This interference can be called "reflexivity."

Here's how the theory of reflexivity applies to the unfolding financial crisis. Contrary to classical economic theory, which assumes perfect knowledge, neither market participants nor the monetary and fiscal authorities can base their decisions purely on knowledge. Their misjudgments and misconceptions affect market prices, and, more important, market prices affect the so-called fundamentals that they are supposed to reflect.

Bubbles and Super-Bubbles

Market prices do not deviate from a theoretical equilibrium in a random manner, as the current paradigm holds. Participants' and regulators' views never correspond to the actual state of affairs; that is to say, markets never reach the equilibrium postulated by economic theory. There is a two-way reflexive connection between perception and reality, which can give rise to initially self-reinforcing but eventually self-defeating boom-bust processes, or bubbles.

Every bubble consists of a trend and a misconception that interact in a reflexive manner. There has been a bubble in the U.S. housing market, but the current crisis is not merely the bursting of the housing bubble. It is bigger than the periodic financial crises we have experienced in our lifetime. All those crises are part of a super-bubble — a long-term reflexive process that has evolved over the last 25 years or so. It consists of a prevailing trend (credit expansion) and a prevailing misconception (market fundamentalism, which holds that markets should be given free rein).

Previous crises served as successful tests, which reinforced the prevailing trend and the prevailing misconception. The current crisis constitutes the turning point at which both the trend and the misconception have become unsustainable. ●



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Rebecca S. Clement, Publisher; Sarah T. Dayton, Editor in Chief; Christine Wright, Senior Graphic Designer; Chris Lauer, Contributing Editor

Setting the Stage

The outbreak of the current financial crisis can be officially fixed at August 2007. That was when the central banks had to intervene to provide liquidity to the banking system. As the BBC reported:

- On Aug. 6, American Home Mortgage, one of the largest U.S. independent home loan providers, filed for bankruptcy after laying off the majority of its staff. The company said it was a victim of the slump in the U.S. housing market that had caught out many subprime borrowers and lenders.

- On Aug. 9, short-term credit markets froze up after a large French bank, BNP Paribas, suspended three of its investment funds worth 2 billion euros, citing problems in the U.S. subprime mortgage sector.

- On Aug. 16, Countrywide Financial, the largest U.S. mortgage originator, drew down its entire \$11.5 billion credit line. Australian mortgage lender Rams also admitted liquidity problems.

Origins

The crisis was slow in coming, but it could have been anticipated several years in advance. It had its origins in the bursting of the Internet bubble in late 2000. The Fed responded by cutting the federal funds rate from 6.5 percent to 3.5 percent within the space of just a few months. Then came the terrorist attack of Sept. 11, 2001. To counteract the disruption of the economy, the Fed continued to lower rates — all the way down to 1 percent by July 2003, the lowest rate in half a century, where it stayed for a full year. For 31 consecutive months the base inflation-adjusted short-term interest rate was negative.

Cheap money engendered a housing bubble, an explosion of leveraged buyouts and other excesses. When money is free, the rational lender will keep lending until there is no one else to lend to.

On June 15, 2007, Bear Stearns announced that two large mortgage hedge funds were having trouble meeting margin calls. Investors' equity of \$1.5 billion was mostly wiped out.

Rattled Markets

The failure of the two Bear Stearns mortgage hedge funds in June badly rattled the markets, but U.S. Federal Reserve chairman Ben Bernanke and other senior officials reassured the public that the subprime problem was an isolated phenomenon.

It was only at the beginning of August that financial markets really took fright. It came as a shock when Bear

Stearns filed for bankruptcy protection for two hedge funds exposed to subprime loans and stopped clients from withdrawing cash from a third fund. Bear Stearns had tried to save these entities by providing \$3.2 billion of additional funding.

Once the crisis erupted, financial markets unraveled with remarkable rapidity. Everything that could go wrong did. A surprisingly large number of weaknesses were revealed in a remarkably short period of time.

Exposure

The current crisis has spread from one segment of the market to others, particularly those that employ newly created structured and synthetic instruments. Both the exposure and the capital base of the major financial institutions have been brought into question, and the uncertainties are likely to remain unresolved for an extended period of time. This is impeding the normal functioning of the financial system and is liable to have far-reaching consequences for the real economy. ●

PART ONE: PERSPECTIVE

The Core Idea

Social events have a different structure from natural phenomena. In natural phenomena there is a causal chain that links one set of facts directly with the next. In human affairs the course of events is more complicated. Not only facts are involved but also the participants' views, and the interplay between them enters into the causal chain. There is a two-way connection between the facts and opinions prevailing at any moment in time: On the one hand participants seek to understand the situation (which includes both facts and opinions); on the other, they seek to influence the situation (which again includes both facts and opinions).

The interplay between the cognitive and manipulative functions intrudes into the causal chain so that the chain does not lead directly from one set of facts to the next but reflects and affects the participants' views. Since those views do not correspond to the facts, they introduce an element of uncertainty into the course of events that is absent from natural phenomena. That element of uncertainty affects both the facts and the participants' views.

Uncertainty

The element of uncertainty inherent in social events can be explained by relying on the correspondence theory of truth (the truth corresponds to the facts) and the concept of reflexivity. Reflexivity has been used in logic to refer to a relation that an object has to itself. Here it is used to

Summary: THE NEW PARADIGM FOR FINANCIAL MARKETS

describe a two-way connection between the participants' thinking and the situation in which they participate.

Misinterpretations of reality and other kinds of misconceptions play a much bigger role in determining the course of events than is generally recognized. That is the main new insight that the theory of reflexivity has to offer. The current financial crisis serves as a persuasive example. ●

Autobiography of a Failed Philosopher

The concepts of reflexivity and fallibility make an important contribution to our understanding, not because they are something novel or original by themselves, but because they can be used to identify and refute widespread and influential misconceptions. One of those misconceptions is the Enlightenment fallacy, which assumes that the purpose of reason is to produce knowledge. It is a fallacy because it ignores the manipulative function.

The financial crisis is a vivid demonstration of how much damage misconceptions can cause. The theory of reflexivity offers a genuine alternative to the currently prevailing paradigm. If the theory of reflexivity is valid, the belief that financial markets tend toward equilibrium is false, and vice versa. ●

The Theory of Reflexivity

People are participants, not just observers, and the knowledge they can acquire is not sufficient to guide them in their actions. They cannot base their decisions on knowledge alone. That is the condition described by the word "fallibility."

Fallibility

Without fallibility there would be no reflexivity — if people could base their decisions on knowledge, the element of uncertainty that characterizes reflexive situations would be removed — but fallibility is not confined to reflexive situations. In other words, fallibility is a more comprehensive condition, and reflexivity is a special case.

People's understanding is inherently imperfect because they are part of reality and a part cannot fully comprehend the whole. Our understanding is imperfect, meaning that it is incomplete and, in ways that cannot be precisely defined, distorted. The human brain cannot grasp reality directly but only through the information it derives from it.

Financial Markets

Reflexivity is best demonstrated and studied in the financial markets because financial markets are supposed to

be governed by scientific laws. In other areas the science is less well developed. Even in the financial markets, demonstrably reflexive processes occur only intermittently.

On a day-by-day basis markets seem to follow certain statistical rules, but occasionally those rules are broken. We may therefore distinguish between humdrum, everyday events that are statistically predictable, and reflexive processes that are not. The latter are of great significance because they alter the course of history.

Reflexivity distinguishes only two functions: the cognitive and the manipulative. It pinpoints a distortion in the way philosophers and scientists tend to look at the world. Their primary concern is the cognitive function: Insofar as the manipulative function interferes with the proper functioning of cognition, they are inclined to ignore it or to deliberately eliminate it from consideration.

The Human Uncertainty Principle

The distinguishing feature of reflexivity is that it introduces an element of uncertainty into the participants' thinking and an element of indeterminacy into the situation in which they participate.

The uncertainty associated with reflexivity affects not only the participants but also the social scientists who seek to establish universally valid laws governing human behavior. This additional element of uncertainty may be described as the human uncertainty principle, and it complicates the task of the social sciences.

The postulate of radical fallibility emphasizes the divergence between reality and the participants' perception of reality, and it focuses attention on misconceptions as a causal factor in history. This leads to a particular interpretation of history that can be illuminating. The present moment is such a time. The current financial crisis can be directly attributed to a false interpretation of how financial markets function. ●

Reflexivity in Financial Markets

The financial markets offer an excellent laboratory because most of the price and other data are public and quantified. The main advantage of financial markets as a laboratory is that the theory of reflexivity is in direct contradiction of a theory that is still widely accepted, namely, the belief that financial markets tend toward equilibrium. If equilibrium theory is correct, reflexivity cannot exist. By the same token if the theory of reflexivity is correct, equilibrium theory is invalid.

The New Paradigm

The new paradigm differs from the old one. By applying the postulate of radical fallibility to financial markets,

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one can assert that, instead of being always right, financial markets are always wrong. Markets have the ability, however, both to correct themselves and occasionally to make their mistakes come true by a reflexive process of self-validation. That is how they can appear to be always right. To be specific, financial markets cannot predict economic downturns accurately, but they can cause them.

Participants act on the basis of imperfect understanding. They base their decisions on incomplete, biased and misconceived interpretations of reality, not on knowledge, and the outcomes are liable to diverge from expectations. The divergence provides useful feedback on the basis of which they can adjust their behavior. Such a process is unlikely to produce satisfactory results all the time.

Equilibrium

Indeed, markets move away from a theoretical equilibrium almost as often as they move toward it, and they can get caught up in initially self-reinforcing but eventually self-defeating processes. Bubbles often lead to financial crises. Crises, in turn, lead to the regulation of financial markets. That is how the financial system has evolved — periodic crises leading to regulatory reforms.

In the absence of regulatory authorities, financial markets would be bound to break down, but in reality breakdowns rarely occur because markets operate under constant supervision, and even if the authorities tend to be sluggish in normal times, they become alert in an emergency — at least in democracies.

Interplay Between Participants and Regulators

Most of the reflexive processes involve an interplay between market participants and regulators. To understand that interplay it is important to remember that the regulators are just as fallible as are the participants. Changes in the regulatory environment place every crisis into a unique historical context. That alone is sufficient to justify the claim that the behavior of markets is best regarded as a historical process.

Market fundamentalists blame market failures on the fallibility of the regulators, and they are half right: Both markets and regulators are fallible. Where market fundamentalists are totally wrong is in claiming that regulations ought to be abolished on account of their fallibility.

The fact that regulators are fallible does not prove that markets are perfect. It merely justifies re-examining and improving the regulatory environment.

So-Called Fundamentals

When do the reflexive connections that are endemic in financial markets turn into self-reinforcing, historically

Caution and Leverage

One of the major differences between the new paradigm and the old one is that the new one takes a more cautionary approach to the use of leverage. The theory of reflexivity recognizes the uncertainties associated with the fallibility of both regulators and market participants. The prevailing paradigm acknowledges only known risks and fails to allow for the consequences of its own deficiencies and misconceptions. This is what lies at the root of the current turmoil.

significant processes which affect not only prices in the financial markets but also the so-called fundamentals that those prices are supposed to reflect? That is the question that a theory of reflexivity has to answer if it is to be of any value.

Based on theoretical arguments and empirical evidence, one hypothesis is that *there has to be both some form of credit or leverage and some kind of misconception or misinterpretation involved for a boom-bust process to develop*. The main insight this conceptual framework has to offer is that misconceptions play a significant role in the making of history. This message is particularly relevant for understanding what is happening in the financial markets at the present moment in history. ●

PART TWO: THE CURRENT CRISIS AND BEYOND

The Super-Bubble Hypothesis

Superimposed on the U.S. housing bubble there is a much larger boom-bust sequence that has finally reached its inflection, or crossover, point. The super-bubble is more complex than the housing bubble.

Boom-bust processes arise out of a reflexive interaction between a prevailing trend and a prevailing misconception. The prevailing trend in the super-bubble is the same as in the housing bubble — ever more sophisticated methods of credit creation — but the misconception is different. It consists of an excessive reliance on the market mechanism.

Long-Term Trends

The super-bubble combines three major trends, each containing at least one defect.

First is the long-term trend toward ever-increasing credit expansion as indicated by rising loan-to-value ratios in housing and consumer loans, and rising volume of credit to gross national product ratios. This trend is

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the result of the countercyclical policies developed in response to the Great Depression. Every time the banking system is endangered, or a recession looms, the financial authorities intervene, bailing out the endangered institutions and stimulating the economy. Their intervention introduces an asymmetric incentive for credit expansion, also known as the moral hazard.

The second trend is the globalization of financial markets, and the third is the progressive removal of financial regulations and the accelerating pace of financial innovations.

Globalization Asymmetry

Globalization also has an asymmetric structure. It favors the United States and other developed countries at the center of the financial system and penalizes the less-developed economies at the periphery. The disparity between the center and the periphery is not widely recognized, but it has played an important role in the development of the super-bubble. And both deregulation and many of the recent innovations were based on the false assumption that markets tend toward equilibrium and deviations are random.

The super-bubble ties together the three trends and the three defects. The first trend can be traced back to the 1930s, but the second and third became firmly established only in the 1980s. So one can date the inception of the super-bubble to the 1980s, because that is when market fundamentalism became the guiding principle of the international financial system.

Housing Bubble

Synthetic financial instruments, risk calculations and proprietary trading models were built on the theory that markets tend toward equilibrium and deviations are random. These innovations took past experience as their starting point, with suitable allowances for deviation and emerging new trends, but they failed to recognize the impact that they themselves made. Households became increasingly dependent on the double-digit appreciation

in house prices. The savings rate dropped below zero, and households withdrew equity by refinancing their mortgages at an ever-increasing rate.

Mortgage equity withdrawals reached nearly a trillion dollars in 2006. When house prices stopped rising, these trends had to moderate and eventually reverse. Households found themselves overexposed and overindebted. Eventually, consumption had to fall. The bust is following the classic boom-bust pattern, but, in addition, it has also set in motion a flight from the dollar and an unwinding of the other excesses introduced into the financial system by recent innovations. That is how the housing bubble and the super-bubble are interconnected.

The current crisis constitutes the inflection or crossover point not only in the housing bubble but also in the long-term super-bubble. The subprime crisis was merely the trigger that released the unwinding of the super-bubble.

Reflexivity

The boom-bust pattern is merely a convincing example of reflexivity. It is convincing because it describes market behavior that is in direct contradiction to the prevailing paradigm, which holds that markets tend toward equilibrium.

The prevailing paradigm cannot explain what is happening; the theory of reflexivity can. The case for abandoning the prevailing paradigm is even stronger: The belief that markets tend toward equilibrium is directly responsible for the current turmoil; it encouraged the regulators to abandon their responsibility and rely on the market mechanism to correct its own excesses. The idea that prices, although they may take random walks, tend to revert to the mean served as the guiding principle for the synthetic financial instruments and investment practices that are currently unraveling.

History

According to the new paradigm, events in financial markets are best interpreted as a form of history. The past is uniquely determined; the future is uncertain. Consequently it is easier to explain how the present position has been reached than it is to predict where it will lead.

History, although it is uniquely determined, is so overcrowded that it would be incomprehensible unless the processes and singular events involved were reduced to manageable numbers. That is where the super-bubble hypothesis can help to select the events and developments that deserve consideration. ●

Market Fundamentalism

President Ronald Reagan called it the magic of the marketplace. Financier George Soros calls it market fundamentalism. It became the dominant creed in 1980 when Reagan became president in the United States and Margaret Thatcher was elected prime minister in the United Kingdom, although its antecedents go back much further.

Autobiography of a Successful Speculator

The technology bubble burst in 2000. Then came the terrorist attack of Sept. 11, 2001. To prevent a recession, the Fed lowered the federal funds rate to 1 percent and kept it there until June 2002. That engendered the housing bubble, in which financial innovations played a major role. With the spreading of risks, more risks could be taken.

Unfortunately, the risks were passed on from those who were supposed to know them to others who were less familiar with them. What is worse, the newly invented methods and instruments were so sophisticated that the regulatory authorities lost the ability to calculate the risk involved. They came to depend on the risk control methods developed by the institutions themselves.

Risk

The various synthetic mortgage securities were based on the assumption that the value of houses in the United States taken as a whole never declines; individual regions may fluctuate, but the market as a whole is stable. That is what made securities spreading the risk over various regions seem more secure than individual mortgages. That assumption ignored the possibility of a nationwide housing bubble of the magnitude that actually occurred.

The regulatory authorities knew that their intervention engendered a moral hazard. They paid lip service to the moral hazard, but when the chips were down they came to the rescue of institutions that were too big to fail. They knew that their intervention introduced asymmetric incentives that favored ever-increasing credit expansion, yet they were so carried away by the prevailing market fundamentalist mood and their own success that they came to believe that markets can self-regulate. That is how credit expansion came to reach unsustainable levels.

Abuses and Excesses

The authorities consistently ignored or underestimated the abuses and excesses in the mortgage industry and the effect on the real economy. That is how the Federal Reserve fell so far behind the curve. The Federal Reserve had the legal authority to regulate the mortgage industry, which it failed to exercise.

The current crisis is incomparably more complicated than the international banking crisis of the 1980s because the mortgages have been sliced up, repackaged and resold, and voluntary cooperation among unknown participants is difficult if not impossible to arrange. Arrangements to provide relief to people who face a sudden jump in interest payments as their teaser rates expire

in the next 18 months will have only very limited effect.

Mortgage service companies are overwhelmed and have no financial incentive to arrange for voluntary adjustments. There are some 2.3 million people in that category, many of whom have been duped by unscrupulous lenders. Altogether, the housing crisis will have far-reaching social consequences. ●

The Soros Outlook for 2008

The theory of reflexivity does not offer any firm predictions. It does help, however, to formulate some conjectures on what the future may hold in store:

1. A 60-year period of credit expansion based on the United States exploiting its position at the center of the global financial system and its control over the international reserve currency has come to an end. The current financial crisis will have more severe and longer-lasting consequences than similar crises in the past. All of this is bound to affect the U.S. economy negatively.

2. One can expect some longer-lasting changes in the character of banking and investment banking. These have been growth industries since 1972, launching ever more sophisticated new products and enjoying ever looser regulation. Regulators will try to regain control over the activities of the industry they are supposed to supervise. How far they go will depend on the severity of the damage. If taxpayers' money is used, Congress will get involved.

3. There are no grounds, however, for predicting a prolonged period of credit contraction or economic decline in the world as a whole because there are countervailing forces at work. China, India and some oil-producing countries are experiencing dynamic developments that may not be significantly disrupted by the financial crisis and a recession in the United States. The U.S. recession itself will be cushioned by an improvement in the current account deficit.

4. The United States during the Bush administration failed to exercise proper political leadership. As a result the United States has suffered a precipitous decline in its power and influence in the world. The invasion of Iraq has much to do with the rise in the price of oil and the unwillingness of the rest of the world to hold dollars. A recession in the United States and the resilience of China, India and the oil-producing countries will reinforce the decline in the power and influence of the United States. The decline of the dollar as the generally accepted reserve currency will have far-reaching political consequences and will raise the specter of a breakdown in the prevailing world order. Generally

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speaking, we are liable to pass through a period of great uncertainty and destruction of financial wealth before a new world order emerges.

Guesswork

These insights are too general to be of much use in practical decision making. To be more specific one needs to engage in guesswork. ●

Some Policy Recommendations

Clearly an unleashed and unhinged financial industry is wreaking havoc with the economy. It needs to be reined in. Credit creation by its nature is a reflexive process. It needs to be regulated in order to prevent excesses. We must remember, however, that regulators are not only human but also bureaucratic. Going overboard with regulations could severely impede economic activity. Markets should be given the greatest possible scope compatible with maintaining economic stability.

The regulators need to gain a better understanding of the recent innovations, and they ought not to allow practices that they do not fully understand. There are systemic risks that need to be managed by the regulatory authorities. To be able to do so they need to have adequate information.

Money Supply and Credit Creation

The most important lesson to be learned from the current crisis is that the monetary authorities have to be concerned not only with controlling the money supply but also with credit creation. Monetary authorities have to be concerned not only with wage inflation but also with avoiding asset bubbles. The monetary authorities have to monitor and take into account not only money supply but also credit conditions.

One specific measure that could help relieve the credit crisis is the establishment of a clearinghouse or exchange for credit default swaps. There is much to be gained by establishing a clearinghouse or exchange with a sound capital structure and strict margin requirements to which all existing and future contracts would have to be submitted.

Avoiding foreclosures ought to be the primary focus of additional policy measures. Both systemic and individualized approaches are needed. ●

Conclusion

Eventually, the U.S. government will have to use taxpayers' money to arrest the decline in house prices. Until it does, the decline will be self-reinforcing, with

people walking away from homes in which they have negative equity and more and more financial institutions becoming insolvent, thus reinforcing both the recession and flight from the dollar.

The Bush administration and most economic forecasters do not understand that markets can be self-reinforcing on the downside as well as the upside. They are waiting for the housing market to find a bottom on its own, but it is further away than you think.

The Bush administration resists using taxpayers' money because of its market fundamentalist ideology and its reluctance to yield power to Congress. It has left the conduct of policy largely to the Federal Reserve. This has put too much of a burden on an institution designed to deal with liquidity, not solvency, problems. With the Bear Stearns rescue operation and the latest-term security lending facility, the Fed has put its own balance sheet at risk. Current policies are inadequate. It will be difficult to stay ahead of the curve.

Insufficient Knowledge

We have to make decisions without having sufficient knowledge at our disposal. Our decisions have great impact. We can do a lot of good or a lot of harm. But we have not learned how to govern ourselves. As a consequence, we live in great uncertainty and grave danger. We need to gain a better understanding of the situation in which we find ourselves. It is difficult to accept uncertainty. It is tempting to try to escape it by kidding ourselves and each other, but that is liable to land us in greater difficulty.

Let this not be the conclusion but the beginning of a concerted effort at better understanding the human condition. Given our increased control over the forces of nature, how can we govern ourselves better? How is the new paradigm for financial markets to be reconciled with the old one? How should financial markets be regulated? How can the international financial system be reformed? How can we deal with global warming and nuclear proliferation? How can we bring about a better world order? These are the questions for which we have to find answers. ●

RECOMMENDED READING LIST

If you liked *The New Paradigm for Financial Markets*, you'll also like:

1. ***Blueprint to a Billion* by David Thomson.** What does it take to become a billion-dollar corporation? This summary has the answer.
2. ***Competing for the Future* by Gary Hamel and C.K. Prahalad.** Create a successful future by transforming your company into a nimble organization.
3. ***Thriving on Chaos* by Tom Peters.** This summary points the way toward success for corporations struggling to maintain or regain markets.

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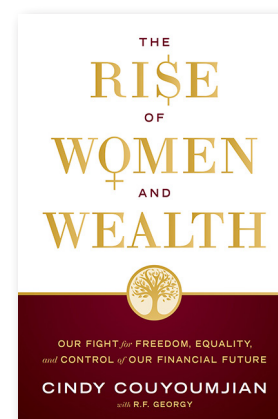
The Rise of Women and Wealth

Cindy Couyoumjian

The Rise of Women and Wealth

Our Fight for Freedom, Equality, and Control of Our Financial Future

by **Cindy Couyoumjian**



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THE SUMMARY IN BRIEF

The founder of Cinergy Financial, Cindy Couymijian, wants to empower women to enter the financial arena in an active way. Her goal is to teach women to assert their right to financial self-determination. Despite the gains women have made in holding high-ranking corporate positions, obtaining higher education, and becoming successful leaders, men still control most of the household wealth in the United States.

Women can be the agents of change within the financial realm. Throughout *The Rise of Women and Wealth: Our Fight for Freedom, Equality, and Control of Our Financial Future*, Cindy shows that women can reclaim their power by confronting America's patriarchal past. Women must find the strength and courage to move forward by gaining an understanding of the past.

The message of this book is hopeful. It is filled with truths and empowerment for women looking for a brighter future, financial freedom, and power. Knowledge is power. This book seeks to help women understand the power dynamic that currently exists and teach them how to assert their unique power. It does this by exploring women's historical, political, economic, and financial knowledge.

IN THIS SUMMARY, YOU WILL LEARN:

- The history of the male-dominated financial realm.
- How to become financially literate.
- How to reclaim financial power and liberty.
- How to apply actionable steps toward achieving financial freedom.

Introduction

There are two financial forces that are converging toward each other to produce a kind of unsettling reality for women. The first is that men in the US control the vast majority of household wealth. The second is that many women are financially dependent upon men. This societal concept of women being economically subservient to men is the reason behind the wage gap and the reason why many women seem to reach a glass ceiling they can't get past. Despite the gains women have made in many other forums, their financial knowledge is alarmingly low.

Some fundamental truths need to be acknowledged. First, women are on the verge of change when it comes to financial awareness and the push for change is happening now. It is also important to note there is a lack of racial diversity in companies where women hold executive positions. The ideas of gender, race and economic opportunity must intersect for women to have equality.

Financial literacy will allow women to demand wage equality, invest in their future, and stop being dependent on men for their financial well-being. Knowledge will give women the power to overcome any obstacles standing in their way.

Part I: Women's Vulnerabilities and Strengths

It's impossible to write about women without peeling away layers of history that have programmed women to feel doubt, alienation, vulnerability, and hesitation at trusting themselves. Our self-image is a result of biographical and historical forces that intersect. One effect is that women have a collective reality centered on suffering. The trauma of being female in a male-centered world has created a sisterhood. This isn't defined by a defined group, only manifested in our fears and doubts.

Sisterhood leads to the idea of mentoring. Women have always shared an implicit bond, so it's no surprise that feminism automatically contains women playing mentorship roles to other women.

Patriarchal trauma is the trauma passed down from generations living in a male-dominated society. Despite a century of demanding change, this structure still exists. The higher up the corporate ladder you climb, the more patriarchal your world becomes. Interestingly, there is surprisingly little research on patriarchal trauma. Perhaps this is because it

has existed for so long that it's hard to study.

We must acknowledge that this trauma extends to men as well. They carry the collective guilt of past generations and have internalized many of the worst masculine qualities. Awareness is required to move forward, but so is confrontation. The good news is that it's changing and there is a new wave of feminism on the rise. With a push toward financial literacy and economic power, this new wave will become a reality.

Part II: Moving Beyond Patriarchy

We are all born into patriarchy. The definition of patriarchy, as I see it, is a socially constructed system that forms the foundation of human interaction based on gender, dominance, control, manipulation, separation, submission, alienation, and a host of other deeply ingrained irrational projections of masculine superiority.

How has patriarchy taken such a foothold in the United States? While America was initially settled by Europeans in search of economic opportunity and freedom, that narrative never applied to women. Women were not granted freedom and opportunity. In early America, women didn't even have a legal identity. The bright spot came with the nation's founding documents – the Declaration of Independence and the Constitution. When women demanded change, the language in these documents allowed them to argue for equality.

It is important to understand that with each successive wave of feminist change, women found themselves closer to realizing their full potential.

The first wave gave women a public voice with the vote. The second wave shattered the illusion that women were happy and fulfilled by domestic work. The third wave exposed the ugly side of patriarchy, which lived in the shadows until women brought global attention to the toxic side of certain men in power. The fourth wave, which I'm calling the financial revolution, will empower women to fulfill their financial destiny.

For patriarchy to completely disappear, women need to be powerful agents of their own financial destiny.

So, why is money important for gaining equality? Because money is power. The power of financial equity offers women other benefits, including financial freedom, lower anxiety levels, the ability to dream, fulfillment, resilience, and self-esteem.

Here's a look at the current reality:

- Women earn about \$0.80 on the dollar compared to men
- Women live longer than men
- Women are more likely to leave the workplace due to other responsibilities
- Women over 80 are more likely to experience income challenges

A lack of financial literacy for women is costly and we need a financial revolution. It's time to take actionable steps to secure our financial future.

Part III: Financial Literacy for Women – A Primer and More

Financial literacy is important to women to increase generational wealth. Wealth transfer helps secure a level of financial freedom and autonomous control that protects women. A great wealth transfer is coming, passed down from the baby boomer generation, and women may emerge as the biggest beneficiaries. Approximately \$30 trillion in wealth is set to change hands in the next decade and women are posed to inherit a sizeable share.

Women are also accumulating their own wealth by climbing the career ladder. They are not only far more educated than those around the 20th century but they're also more educated than their male contemporaries. Sadly, however, they continue to earn substantially less than men for the same work. Both government and private sector must take actionable steps to ameliorate this glaring pay gap. They must focus on enforcing equal pay, reviewing contractor pay practices, and combating pay discrimination for women of color.

Hidden Risks Affecting Your Financial Future

It's time to explore some of the hidden risks. Many overlapping variables have an influence. Understanding them can be the difference between financial freedom and economic dependency.

There are ten types of risk:

- Political risk is the risk that your returns can suffer due to political changes.
- Economic/Globalization risk refers to conditions in the economy that affect investments.

- Federal Reserve risk is the interest rate
- Corporate risk is related to stimulation programs and buybacks for large corporations from the Federal government
- Correlation risk is the assumption that stocks and bonds move together but in opposite directions
- Regulation risk refers to the relationship between the government and the free-market system.
- Longevity risk is emotional. It's the fear of running out of money during retirement.
- Ideological risk is the hidden risk of political ideologies impacting the economy.
- Social Media risk involves the risk of thinking we are smarter than we really are or accepting information without factual evidence.
- Gender risk is the prevailing myth that women are not as smart about money as men.

Despite the fact that women have been led to believe they are poor investors simply as a result of their gender, they have managed to outperform men. While this is great news, it can be misleading. As a general rule, having more money to invest leads to more robust wealth accumulation.

There are hidden forces that may be invisible but are ever present and can, and often do, influence your money. In addition to the hidden forces and hidden risks, you need to be aware of the actors (some hidden and some not) - the Federal Reserve, technological innovation, and social media - that may have a direct impact on your investment strategy.

All these risks are important to understand if you have invested in stocks or even have a 60/40 stock-bond portfolio. The market continues to become more volatile. If you wish to stay protected from these unnecessary risks, it is critical to take the help of a qualified and experienced financial advisor and begin asking the right questions. For example, you may want to ask about why bonds are paying close to zero or what is an appropriate exposure to the stock market. You may also want to inquire about adding alternative investments to your portfolio.

The Intersection Between Political and Economic Risk

There are numerous examples of how politics and economics intersect. They interact with each other in a way that significantly impacts your financial future. Therefore, saving

early and investing early is important. Corporations will continue to manipulate rules to maximize profits and you need to protect yourself.

America today is dominated by a concentration of corporate powers. The problem with a corporate state is that it challenges some of the core concepts of a democratic society. Today, corporate consolidation of entire industries across the globe suggests that a few dozen large companies rule the world.

How does this impact women? Women were largely excluded from the economic profession and corporate boards. The only way to fight this back would be to invest intelligently.

A REALM of Possibilities

The word “realm” refers to an area of knowledge or expertise in some field. Knowledge can be accumulated by reading about subjects and experiencing the world. Innovation, however, is the result of epiphanies, which are sudden bursts of insight or inspiration that comes to us.

To make innovation happen, it's important to recognize why the old ways of doing things didn't work. To invest intelligently, it's important to understand why the 60/40 portfolio leaves 60 percent of your investments and equities at risk due to the volatility of the market.

Today's low-yield environment means the diversification benefit from bonds will not be as large as in the past. If both stocks and bonds have a bad year, you might end up losing most of your wealth.

Today, the two-asset class 60/40 is no longer a viable retirement vehicle. To help people manage and grow their wealth I created a multi-asset class model that rests on three pillars: passive, tactical, and alternative strategies. This fluid and flexible model is enough to accommodate different levels of allocation based on each client's needs and is known as REALM.

REALM stands for Retail Endowment Allocation Like Model. It's a strategy for securing financial freedom and a crucial tool for women to develop financial literacy. It helps women position their wealth in such a way that it continues to grow with lower risks and improved results.

on the verge of extraordinary advancements. In every conceivable field of human activity, women are embracing their destiny by climbing up the male-dominated hierarchy. In corporate America, women need not only knock on the doors of the executive suites, but also push these doors wide open and demand fairness.

One of the unintended consequences of the COVID-19 pandemic is that it forced many people to establish an online business presence. Women are becoming digital entrepreneurs in greater numbers than ever before. After being largely excluded from the first three waves of the industrial revolution, women are currently laying the foundation for the digital revolution.

Finally, women need to break free from the insidious myth that they aren't good investors. Research shows that women are better investors, because they are thoughtful, careful, patient, and seek the advice of professionals. Financial independence is a critical component of gender equality. The fourth wave of feminine change is the financial revolution currently underway.

Conclusion

The future for women is full of challenges, but also possibilities. For the first time in human history, women are



Cindy Couyoumjian is the author of the Wall Street Journal and Amazon best-selling book, *Redefining Financial Literacy*. She is the founder Cinergy Financial with over thirty-six years of experience in the financial industry. Cindy is the architect behind the REALM investment portfolio. Beyond the numerous financial services Cindy offers, she is also an educator and motivational speaker.

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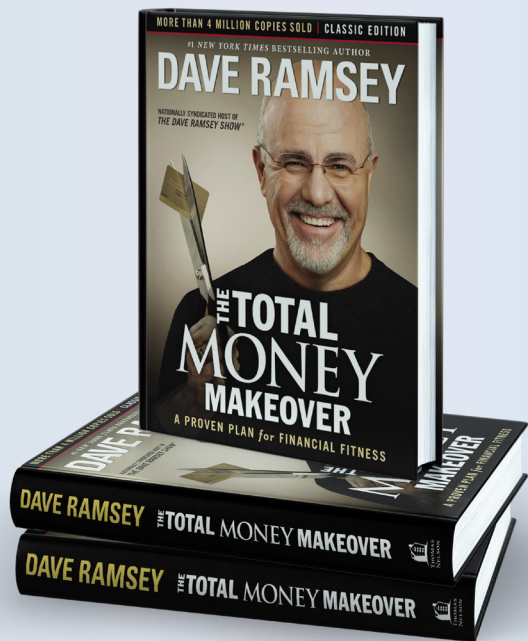
· Book 40 of 44 ·

The Total Money Makeover

Dave Ramsey

BOOK SNAPS™

Zooming In On Your Next Read



The Total Money Makeover

By Dave Ramsey

Dave Ramsey is America's trusted voice on money and business. He's authored five New York Times best-selling books: *Financial Peace*, *More Than Enough*, *The Total Money Makeover*, *EntreLeadership*, and *Smart Money Smart Kids*. "The Dave Ramsey Show" is heard by more than 8.5 million listeners each week on more than 550 radio stations, "The Dave Ramsey Show" channel on iHeart-Radio, and a 24-hour online streaming video channel. Ramsey Solutions offers a suite of products and services to help people get control of their finances and other aspects of their lives.

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3rd Edition

A Proven Plan for Financial Fitness

Many years ago, Dave Ramsey answered a calling that has since helped millions of people "set themselves free financially." Ramsey believes that most of us understand the common sense of what we are supposed to do with money but we don't actually do it. He says that "personal finance is 80 percent behavior and only 20 percent head knowledge." The main problem people have with their money is the person "in the mirror." He realized "that to change your money thing, you have to change. When you change your life, you will get out of debt, give, and invest at an unbelievable rate."

American families work hard, yet they find themselves financially "sick and tired." Becoming financially healthy leads to positive changes in all aspects of a person's life. Ramsey's *The Total Money Makeover* is the tool a person of any income level can use to realize financial health and wellbeing and, perhaps most importantly, it gives these exhausted families hope for a strong financial future. Ramsey's book provides people with a plan that focuses on the how of wealth building, not on the what, inspiring "readers to take immediate action through a simple, step-by-step process that leads to life-changing results."

Ramsey does, in fact, have the education, licenses, and experience that make him a credible financial advisor. However, this is not something he stresses when inviting people to take his makeover challenge. Refreshingly, the most important qualification he leverages for teaching others about money is that he has "done stupid things with zeros on the end. He has been there, done that. He has a PHD in D-U-M-B. He knows what it is like to be scared and scarred. He knows what it is like to have his marriage hanging by a thread because of financial stress. He knows what it is like to have his hopes and dreams crushed by his own stupid decisions. That qualifies him uniquely to teach and to love people who are hurting financially."

If you count yourself among the masses of Americans who are ready to get their financial house in order, Ramsey has great news for you. You can do it if you will do it. It's entirely your responsibility to "confront that [wo]man in the mirror," get moving, and cross that finish line.



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Just Fine

When your physical body becomes overweight, it is difficult to deny that it's happening. Your pants become harder to button and your belt has to be continually widened. When you are "financially fat" it is far easier to deny you have a problem. You look in the mirror and things look pretty good. You have a house, a car or two, a student loan, and some credit card debt, all which are manageable with your salary. But what if you get laid off? What if your meager savings aren't enough to cover a totally unexpected large expense? People in this position become "apathetic because everything seems just fine." Ramsey says you are actually in denial and that puts you in much "greater danger" than you realize.

The problem with denial is that financial demise usually happens slowly over time. We believe that everything is okay when in reality, we are becoming complacent and it just may spell the end for us. Like a frog slowly boiling to death in a pot of water, we think we are okay but our lives are actually on the line.

Ramsey writes, "The enemy of 'the best' is not 'the worst.' The enemy of the best is 'just fine.'" Many of us won't find the courage and focus to change until we are in pain. If you are trying to avoid heart failure, you would be wise to "cut the carbs, the fats, the sugars, and lace up the running shoes now." The same is true when you want to avoid financial ruin. You have to start moving towards freedom now. Refuse to live with being "just fine" and take on the "pain of change" before "the pain of where you are" is too great.

There's No Such Thing as Easy Money

When it comes to money, so many people search in vain for a shortcut. No matter how much we long to "become healthy, wealthy, and wise with no effort and with no risk, it will never happen." The old adage that says "if it seems too good to be true, it probably is" holds firm when it comes to making money. Get rich quick schemes and risk denial are symptoms of our desire to win without effort. They are a "kind of laziness" that permeates our society and makes people fall again and again for a lie that will only lead to loss. "Money denial always involves an illusion, followed by disillusionment."

Any "investment" that promises to yield ridiculously good returns is a scam. If a program promises to earn you a six-figure income working only a few hours a week, you should run as fast as you can in the other direction. If you think that your future will be built on winning the lottery, if you only play frequently enough, you are delusional. These promises are lies and these programs are garbage. They are designed to trick you, extracting as much money as possible from you, not funneling it towards you.

The Ingrained Myth of Debt

Americans are living a lie so ingrained in our society that it has reached myth status. We are repeatedly sold the idea that taking on debt is just the way things are done. It is the way we get the

things that we want now without having to wait. Ramsey asserts, "The financial and banking industries, in particular, are very good at teaching us their way of handling money, which, of course, leads us to buy their products." Since everyone around us is doing it that very same way, we think it is normal, "even if it is stupid." Worse still, we buy into the myth so completely that we sell the idea to everyone around us, further perpetuating the false belief that this is what is best for all of us.

Our cultural view of debt is one of the major barriers holding us back from financial freedom. Oddly, when we decide to get ourselves out of debt and start taking steps to do that, we are often faced with "ridicule" from family and friends around us. Those still mired in the myth of debt cannot conceive of a "car without a payment, a house without a mortgage, a student without a loan, and credit without a card." The myth is insidious and difficult to deny.

We are taught that debt is "a tool that should be used to create prosperity." Ramsey points out that debt actually "adds considerable risk, most often doesn't bring prosperity, and isn't used by wealthy people nearly as much as we are led to believe." In fact, many rich people "detest debt." The Forbes 400 is a list of the 400 richest people in America, published by Forbes magazine. 75% of the people on that list responded in a survey that "the best way to build wealth is to become and stay debt-free." Debt is "the most aggressively marketed product in our culture today." Escape being a mythsayer, don't believe the lie, and put a target on your debt until you have completely eliminated it.

The Debt Snowball

One of the most impactful tools that Ramsey teaches to get back on the right track financially is The Debt Snowball. He begins with the premise that "your most powerful wealth-building tool is your income." No matter how creatively you think or hard you focus on investing in the right instruments, you will not be able to build wealth "until you get control and full use of your income." Paramount to that idea is the elimination of debt. Debt is "the enemy" in your fight for financial freedom.

A typical family has "a car payment, a student loan, credit cards, medical bills, and a mortgage." Think about what would happen if that family didn't have those payments. Ramsey illustrates the math. He assumes that the payments of a normal family come to \$1995 per month. If that money were invested "instead of being sent to creditors, they would be cash mutual-fund millionaires in just fifteen years!" The following years would bring on compounding interest, making the fund grow even faster. In just 28 years, that family would have \$5.5 million. It's all about having the money available to invest, which requires the elimination of debt.

People always find it hard to see how they can get there, but Ramsey encourages readers to hear him out. He has walked this path with so many before and knows it can work for you, too. The Debt Snowball is the place to start. Ramsey makes no bones about it. His method is "very difficult" but it is also "foolproof." Here's how it works.



In order to successfully snowball your debt, you have to be intensely focused. You have to be willing to put “getting out of debt” at the top of your priority list and really mean it.

- List all of your debts from smallest to largest, excluding the mortgage. Listing them this way allows for some “quick wins,” which fuels motivation and gets you fired up. Do not underestimate the psychological power of these initial pay-offs on small debts. They will be instrumental in changing behavior, which is key to success.
- “Pay the minimum payment to stay current on all debts except the smallest.” Every spare nickel you have available should go “towards that smallest debt until it is paid.” Once it is paid off completely, you pump your fist and move on to the next one on the list.
- Now, all the money you had been paying to the smallest debt gets paid towards the next debt on your list. On top of that, you throw any extra money you find on top. Once you get going, you will be shocked to see how much money you start “finding.”
- Here’s where it gets good. You attack the debts, one after the other. “Everytime the Snowball rolls over, it picks up more snow and gets larger, and by the time you get to the bottom, you have an avalanche.”
- As you near the bottom of this list, you will find that you have “well over \$1000” available to put towards larger debts like the car payment or student loan. “At that point, it won’t take long to bust out and be debt-free except for the house.”

In order to successfully snowball your debt, you have to be intensely focused. You have to be willing to put “getting out of debt” at the top of your priority list and really mean it. It requires sacrifice, strict budgeting, and commitment.

A Firm Foundation and Retiring With Dignity

After you have attacked your debt successfully, Ramsey recommends you save \$1000 as a start to an emergency fund. Things will start feeling really great at that point and your confidence will be soaring. Now, it’s time to work on “fully funding” the emergency account, which should cover “three to six months of expenses,” depending on your circumstances. Someone in a more “stable” job situation, such as long-term government employment, can get by with a three-month fund. Those in riskier situations, such as a real estate agent, should go with a six-month fund.

This stockpile is where you will turn when the unexpected happens, and data shows that it will happen to most of us. “Money magazine says that 78 percent of us will have a major unex-

pected event within the next ten years.” An emergency fund will ensure that you get through it on your feet. This “big savings account” will be the “strong foundation in your financial house.”

The next focus of your financial attention needs to go towards investing for retirement. In our society, retirement has turned into “saving enough money so you can quit the job you hate.” Ramsey does not believe in that jaded view. Instead, retirement should be synonymous with “security.” In retirement, your money should be working harder than you do, giving you the option to choose how you spend your time. To retire “with dignity” you need to invest “15% of your gross income” in a mutual fund. Ramsey submits that “there is no excuse to retire without dignity in the United States today.” Over a working life, most people will see “well over \$2 million pass through their hands.” You have to “do something about catching some of that money.”

The Total Money Makeover was originally published in 2003 and has sold more than five million copies. The program’s endurance alone is a testament to its efficacy. Legions of Americans have followed the method to gain financial freedom and are evangelical in their praise for it, which adds to its lasting power. Ramsey has a unique voice that pulls readers in and makes them immediately feel understood and empowered. This ability to relate, which stems from his own experience climbing out of financial ruin, serves as a potent catalyst, encouraging people who feel completely out of control to get back in the driver’s seat.

Ingeniously, Ramsey likens the entire process to the act of getting physically fit, which is a familiar concept to nearly every American. You can start this process being “financially flabby, overweight with debt, out of shape in savings, and in desperate need of a personal trainer.” Ramsey assumes that leadership position naturally and genuinely, guiding readers along to financial health. His directness, disenfranchisement with government, humor, and Christianity only add to his allure and receptiveness with his targeted audience.

Throughout the book, Ramsey tells readers “if you will live like no one else, later you can live like no one else.” This sums up Ramsey’s approach perfectly. To achieve financial fitness, you must break away from what the rest of society is doing, because they are doing it wrong. Sacrifice and be different today and you will be afforded a financially bright future tomorrow and forever more.

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The Trillion Dollar Meltdown



The Trillion Dollar Meltdown

Easy Money, High Rollers, and the Great Credit Crash

THE SUMMARY IN BRIEF

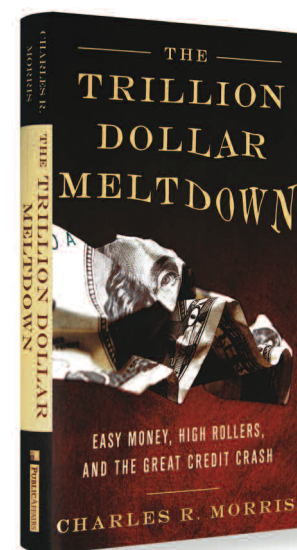
According to acclaimed financial writer Charles R. Morris, we are living in the most reckless financial environment in recent history. Morris warns that the sub-prime mortgage crisis is only a preview of the havoc that will play out across the full spectrum of financial assets.

Morris warns that a quarter century of free-market zealotry that extolled asset stripping, abusive lending and hedge fund secrecy will go down in flames with it. He also predicts that the required restructuring will be at least as painful as the very difficult period of 1979 to 1983.

The Trillion Dollar Meltdown explains the arcane financial instruments, the chicanery, the policy misjudgments, the dogmas and the delusions that created the greatest credit bubble in world history. It also warns that continual denial and concealment could cause the crisis to stretch out for years if financial and government leaders continue to downplay the problem. Morris helps readers understand how the world economy has been put on the brink — and the radically reshaped political/economic landscape that will define the post-crash era.

IN THIS SUMMARY, YOU WILL LEARN:

- How to grasp the breakdown in financial markets that affects the entire world economy.
- How America's shift from a creditor nation to a debtor nation affects Americans and the rest of the world's population.
- What two paths can be followed to raise the savings we need to invest and grow.
- How the American government and finance executives continue on a course to disaster by tending to downplay and conceal problems.



by Charles R. Morris

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THE COMPLETE SUMMARY: THE TRILLION DOLLAR MELTDOWN

by Charles R. Morris

The author: Charles R. Morris has written 10 books, including *The Cost of Good Intentions*, one of *The New York Times*' Best Books of 1980; *The Coming Global Boom*, a *New York Times* Notable Book of 1990; and *The Tycoons*, a *Barrons*' Best Book of 2005. A lawyer and former banker, Morris' articles and reviews have appeared in many publications including *The Atlantic Monthly*, *The New York Times* and *The Wall Street Journal*.

The Trillion Dollar Meltdown by Charles R. Morris. Copyright © 2008 by Charles R. Morris. Summarized by permission of the publisher, PublicAffairs™, 194 pages, \$22.95, ISBN 978-1-58648-563-4.

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The Death of Liberalism

In its modern sense, liberalism is a theory of government posing as a branch of economics. Adam Smith and David Ricardo called their discipline *political economy*, a useful term. "Political" was dropped from the name when the 20th century marriage of economics and advanced mathematics fostered the illusion that economics is a science. But the empirical underpinnings of public economics, the branches that seek to inform government policy, are often so fragile that they are better understood as ideologies.

The Keynesian version of political economy that John Kennedy ostentatiously brought to Washington in 1961 was an expression of faith in the potential of high intelligence employed in activist government. Built in part from nostalgic exaggerations of the accomplishments of the New Deal and the war administration, its central premise was that an economic intelligentsia could reliably employ government levers to achieve specific outcomes in the real world.

In practice, Kennedy's economic policies were cautious. The economic centerpiece of his short administration — generating a recovery with a tax cut — was implemented only well after a recovery was already under way. For Richard Nixon, the central attraction of Keynesian activism was how well it played with the public. The main goal of Nixon's radical centralization of economic controls in 1971, after all, was a landslide re-election.

Faith in a Puppet-Master Government

It is hard to exaggerate the faith of 1970s- and 1980s-vintage liberals in the power of a puppet-master government. An early-1980s survey of America's industrial

decline concluded that America's woes came down to a lack of industrial policy. A Massachusetts Institute of Technology study of Japan concluded, "Without a strong central state and a top professional bureaucracy — the two preconditions of industrial policy — America is doomed to economic decline."

The infatuation with Japan's strategies for America reached its peak just about the time Japan was entering an economic slough that was to drag on for 15 painful years. Prolonged declines in both Germany and France during roughly the same period, if not as serious as Japan's, provoked widespread worries over incurable "eurosclerosis" caused by excessive governmental economic steering.

With the eclipse of Keynesian liberalism, the day had finally dawned for an alternative paradigm that had been waiting patiently in the wings — Milton Friedman's "monetarism."

Friedman's Monetarists

Monetarists taught that the supply of money was the product of the *stock* of money — the sum of coins, bills, checking accounts, etc. — times its turnover rate, or its *velocity*. Most important, by establishing rigid rules for monetary management, officials' meddlesome impulses would be constrained.

While Keynesians prayed to the idol of the quasi-omniscient technocrat, the Friedmanite religion enshrined the untrammelled workings of free-market capitalism. (Friedman opposed almost all forms of government regulation, including safety regulation for pharmaceuticals.)

Ronald Reagan's election in 1980 signaled that Keynesian liberalism was dead. Vaguely, inchoately, but



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Rebecca S. Clement, Publisher; Sarah T. Dayton, Editor in Chief; Chris Lauer, Senior Editor; Chris Bienick, Graphic Designer

A Feast of Low Points for the American Economy

For connoisseurs of misery, the 10 years from 1973 through 1982 provide a feast of low points. The rate of economic growth was one of the worst for any comparable period since the end of World War II. The country endured one of the worst periods of inflation in American history and foreign investors fled the dollar as if it were the Mexican peso.

The Japanese humiliated American standard-bearers in one flagship industry after another. Layoffs and short shifts spread through heavy industry. America's once-humming industrial heartland transmuted into the Rust Belt.

unquestionably, voters had signaled their readiness for a change of ideological horses. The theorists of the free market would get to run their race. ●

Wall Street Finds Religion

Few people had ever heard of the World Wide Web and the Internet before a startup company called Netscape — it sold the first Web browser that ordinary people could use — executed its public stock issuance in August 1995. The stock tripled on the first day, and within a few months, Jim Clark, a Silicon Valley veteran who was Netscape's primary investor, was the world's first dot-com billionaire. The tech stock boom was on.

Alan Greenspan

As the frenzy fed on itself, Federal Reserve Chairman Alan Greenspan worried publicly about “irrational exuberance” in 1996, then reversed himself a year later, cautiously accepting the possibility of a “new paradigm” — presaging an era of technology-enabled noninflationary growth. It was a remark almost guaranteed to increase the giddiness.

Bubbles are almost always anchored in real developments. The Web and the Internet were truly revolutionary and probably as important as the railroads. Secure Web-enabled communication flattened out organizational charts in big companies, blew away layers of bureaucracy, tied together customers and suppliers, and allowed seamless outsourcing of non-core tasks. Productivity growth in the last half of the decade ran at an extremely high annual rate of 4 percent plus.

Greenspan, something of an antiregulatory zealot, has never believed that asset bubbles are the business of the Fed. In the late 1990s, he refused to tighten stock margin rules to take some air out of the tech bubble.

Clinton's Legacy

The implosion of the tech bubble came only after President Bill Clinton had already turned over the White House keys, allowing him to leave office with a gaudy set of economic accomplishments. Over his entire administration, real growth had averaged 3.7 percent, the best postwar record except for the Kennedy/Johnson years. During Clinton's last three years in office, the government ran surpluses in excess of \$300 billion, the best performance in the postwar era.

How did he do it? The official line, pushed especially hard by Robert Rubin, the head of the Domestic Policy Council and late of Goldman Sachs, is that it was through the application of “Rubinomics” — cutting deficits to lower interest rates. It is the same order of nonsense as the supply-sider's insistence that all booms are rooted in tax cuts. Rafts of studies by both liberal and conservative economists show that big deficit reductions move long-term interest rates by a few tenths of a percent, if at all. The deficit-cutting effort by Clinton's tax increase, in any case, was overwhelmed by the upsurge in gains taxes from the riotous stock market.

Broader Forces

The 1990s boom, in fact, was rooted in the confluence of a host of much broader forces that almost ensured solid growth. The baby boomers, the generation that had so decisively stamped its imprint on every decade since the 1950s, were entering their 40s and 50s — the years of greatest work output and savings. There was a productivity boom in American factories. The boomer generation of managers not only absorbed Japanese practices but also drew on uniquely American developments in distributed computing and digital communications that were just coming into full flower.

After a decade of overinvestment in real estate, the vast flow of liquidity in pension and mutual funds was shifting back to stocks and bonds. The senior population was flat, military spending was falling and new surpluses from a 1983 Social Security tax increase were cutting into the big Reagan-era deficits. Put all that together, and falling interest rates and strongly rising financial markets looked inevitable.

Then there were the 40 years of government investment that designed and implemented the Internet, including most of its core technologies, built it into a working worldwide system and developed the strategy and organizational model for shifting the Internet from government to private-sector control in 1995. Compared to such tidal developments, the Rubin tax increase was background static.

Summary: THE TRILLION DOLLAR MELTDOWN

Conservative Convictions

Despite its unevenness, the 1980s and 1990s economic experience strengthened conservative conviction in two core principles. The first, which had been amply demonstrated by the recoveries of the early 1980s and the 1990s, was the great power of free markets. The second was the importance of almost fully deregulated financial markets, which was odd because multiple market bubbles were a strong argument to the contrary. ●

Bubble Land: Practice Runs

Although exciting new technologies fueled the dot-com boom, the bubble itself was a standard case of stock market hype and overshoot. But the decade from the late 1980s to the late 1990s also saw three other, much different boom-and-bust cycles. There was a big crash in residential mortgages in 1994 and two big trading-based crises — the 1987 stock market crash and the 1998 Long-Term Capital Management crisis, which the Federal Reserve at one point feared might bring down the entire global finance system.

All three of those episodes arose from fundamentally new investment technologies, enabled by breakthroughs in desktop computing and by an influx of mathematics Ph.D.s to Wall Street. Large-volume computerized trading could exploit tiny changes in interest rates. Very broad new classes of complex, structured investment instruments revolutionized wholesale banking. All the new technologies and strategies harbored dangerous flaws that tended to reveal themselves only at points of great stress. Bigger, better, even more far-reaching versions of these strategies have now, in 2008, placed the entire global economy at risk.

Geologic Shifts

Three episodes illustrate the tectonic shifts in the financial markets of the 1980s and 1990s, and expose some of the seismic fault lines in the new terrain.

First, the relentless deregulation drive that started during the Reagan administration steadily shifted lending activities to the purview of nonregulated entities, until by 2006, only about a quarter of all lending occurred in regulated sectors, down from about 80 percent 20 years before.

A second fault line is a worsening of the “agency” problem — or the problem of ensuring that an employee, a contractor or a company performing a service doesn’t act against your interest. A young trader named Nick Leeson destroyed Barings Bank in 1997 by taking exorbitant trading risks. By consensus, that was Barings’ own fault.

Alan Greenspan’s Implausible Argument

Dogmatic market capitalists hailed the deregulation trend, none more enthusiastically than Federal Reserve Chairman Alan Greenspan. In 1995, for example, Greenspan argued against margin — or minimum capital — rules on derivative positions. He claimed, implausibly, that a *lack* of margin requirements would “promote the safety and soundness of broker-dealers, by permitting more financial alternatives and, hence, more effective liquidity management.”

Highly compensated traders playing with the house’s money are an extreme, and well-known, case of the agency problem, so most trading houses have developed elaborate risk-control procedures to protect themselves. Barings didn’t, and paid for it.

Finally, a third dangerous trend is the increased dominance of investment decisions by mathematical constructs. The mathematics of big portfolios analogizes price movements to models of heat diffusion and the motions of gas molecules, in which uncountable randomized microinteractions lead to highly predictable macro results. Although it’s theoretically possible that all the air molecules in a room will shift to one corner, or that a torch applied to a metal bar will heat only one side, the laws of large numbers ensure that the actual frequency of such events is way beyond never.

Large securities portfolios usually do behave more or less as the mathematics suggest. But the analogies break down in times of stress. For shares truly to mirror gas molecules, trading would have to be costless, instantaneous and continuous. In fact, it is lumpy, expensive and intermittent. Trading is also driven by human choices that often make no sense in terms that models understand.

All three of those trends — the shift of financial transactions to unregulated markets, the steady worsening of the agency problem and the pretense that all finance can be mathematized — flowed together to create the great credit bubble of the 2000s. ●

A Wall of Money

By 2003 or so, mortgage lenders were running out of people they could plausibly lend to. Instead of curtailing lending, they spread their nets to vacuum up prospects with little hope of repaying their loans. Subprime lending jumped from an annual volume of \$145 billion in 2001 to \$625 billion in 2005, more than 20 percent of total issuances. More than a third of subprime loans were for

Summary: THE TRILLION DOLLAR MELTDOWN

100 percent of the home's value — even more when the fees were added in.

“Negative amortizations” were loans with initial payments that didn't cover interest, but the unpaid interest was added to the principal at killer rates. Gross overcharges for fees and brokerage were buried in the loan principal. The standard lender escrow accounts to ensure the payment of taxes and insurance were eliminated. Borrowers thought their monthly payments were smaller and quickly defaulted on insurance and tax payments. “Yield spread premium” fees for brokers were bonuses for originating high-rate loans for borrowers who qualified for better deals.

The industry's underbelly became viciously predatory: A mortgage might include several different loans at teaser rates that quickly reset to double or triple the initial rates. The new monthly payments frequently were higher than the borrower's total income.

Falling House Prices

As of the end of 2007, the industry borders on catastrophe. The housing boom is over: The widely followed Case-Shiller index of home re-sales shows that real home prices have fallen steadily throughout 2007. (As late as 2006, the forecasting consensus was that house prices never fall.) Chasing the numbers down, most economists now anticipate a real national price drop in the 10 percent range, although outside estimates are creeping toward 30 percent.

Pessimism is fully warranted. Some \$350 billion worth of subprime and near subprime loans closed in 2005 and 2006 will reset, most at much higher interest rates over the next year or so. Delinquencies have been rising rapidly and, given the very low quality of recent-vintage loans, can only accelerate.

Extreme Leveraging

The extreme leveraging in the financial sector started to come undone in October, when the big banks and investment banks reported some \$20 billion in losses, \$11 billion of it at Citi and Merrill, primarily in subprime-based collateralized debt obligations (CDOs). The first reaction was relief that the banks were finally coming clean. But within just a couple of weeks, banks revised their loss estimates to more than \$45 billion, including recalculations of the third quarter and new losses in October. Some \$20 billion was reported by Citi and Merrill. Merrill's CEO, Stan O'Neal, was fired, and Citi's Chuck Prince resigned.

As of late November, the market bottom is rapidly receding into an endless black hole.

Why isn't the Fed stepping in much more aggressively? The sad fact is that there isn't much the Fed can do.

All the years of working the liquidity pump has sucked out everything but the brine. The “wall of money” that has kept American markets afloat also created a global dollar tsunami that has left a waterlogged world in its wake. ●

A Tsunami of Dollars

The standard fever chart of a country's financial position vis-à-vis the rest of the world is its “current account,” a kind of international profit and loss statement. Although the current account captures all international spending flows, such as tourist spending and earnings from overseas companies, the numbers are dominated by exports and imports. American exports, or everything we sell overseas, go on the plus side of the ledger, while the goods and services we buy from abroad are entered on the minus side.

For about 75 years starting in the mid-1890s, the American current account was always strongly in the black. Even during the 1970s oil crisis, the deficit never exceeded \$15 billion. The strong flow of earnings from overseas assets usually offset about half of the oil bill.

Shifting Trade

The trade account deteriorated steadily through the 1980s and 1990s, before suddenly tilting into a free fall around 1999. The 2006 trade deficit was more than \$750 billion, and the total current account deficit topped \$800 billion.

The accumulated deficit for 2000 to 2006 is about \$4 trillion. Under pressure from the falling dollar, trade numbers improved in the second half of 2007, but the full-year deficit will still be a humongous \$650 billion or so.

The \$800 billion net outflow in 2006 was more than 6 percent of American GDP. Where did that money come from?

The answer, of course, is that our deficits are being financed by foreigners — in 2006, the American current account deficit consumed about 70 percent of the rest of the world's surpluses. Most of it comes from private investors — although “private investors” from Russia, China and the Gulf countries are frequently government fronts — but an increasing amount comes from official sources, mostly central banks. That is a big change. In 2000 and 2001, official sources supplied only about \$35 billion a year, but by 2006, the official sources line had ballooned to \$440 billion. Much of that, it is safe to assume, are investments made for policy reasons, not because short-term U.S. Treasuries offer unbeatable returns — and policy decisions can be reversed.

At the end of 2006, America's net investment position showed a balance of \$2.5 trillion in favor of foreigners.

Summary: THE TRILLION DOLLAR MELTDOWN

Trillions Abroad

One concern is the large concentrations of cash-like dollar assets held either directly at central banks or other government-controlled bodies. And they are very concentrated. China has \$1.2 trillion, as does the rest of non-Chinese Asia. The accumulations in the OPEC nations are perhaps \$600 billion. Russia has about \$400 billion and even traditional debtor countries such as Mexico and Brazil have large dollar balances. Total foreign-held dollar reserves as of the end of 2006 were somewhere in the neighborhood of \$5 trillion.

For several years, some very smart people have been arguing that there was little cause for concern because the current dispensation could be maintained indefinitely. But the rapid fall of the dollar in the last half of 2007 suggests that such hopes were wishful thinking.

Two Paths

There are only two paths to raising the savings we need to invest and grow. The first is to make deep and wrenching changes in the way Americans use their money. The second is to attract some of it back from abroad. As a practical matter, we will have to do both. But the days when foreigners were willing to finance our deficits for free are gone forever.

All in all, it's hard to imagine a worse outcome — the United States, the “hyperpower,” the global leader in the efficiency of its markets and the productivity of its businesses and workers, hopelessly in hock to some of the world's most unsavory regimes. But that's where a quarter century of diligent sacrifice to the gods of the free market has brought us. ●

The Great Unwinding

Lenders or companies that want to get risky assets off their books could package and sell them as collateralized debt obligations, or CDOs. Suppose you own a portfolio of high-yield bonds with a below-investment-grade rating. To construct the CDO, you put the portfolio into a trust and create a family of bonds with different claims to the portfolio's cash flows. The top-tier bonds, which might be 80 percent of the total, get first dibs on *all* cash flows. Since those bonds are almost certain to be fully paid, they get a top credit rating, and conservative investors, like pension funds, are happy to take them off your hands. The rest of the bonds are queued up in the payments “water-fall,” with each successive layer bearing greater risk, paying higher yields and getting lower ratings.

Credit default swaps can be used to create synthetic CDOs. A credit default swap allows the holder of the

risky asset to lay off the risk to a third party, without having to sell the asset. With imagination, some advanced math and some computer wizardry, a family of credit default swaps can be constructed that will generate exactly the same risks and cash flows as a real reference CDO portfolio but without the trouble of actually assembling the loans — a synthetic CDO.

Synthetic CDOs

The growth of synthetics means that the actual supply of real subprime mortgages or highly leveraged corporate loans is no longer a limit on creating CDOs based on those instruments. There is also a tendency for synthetic CDOs to distribute only the riskiest, highest-yielding layers to outside investors, so they may increase the proportion of high-risk paper in the market.

The limiting factor in creating CDOs is finding buyers for the bottom tranche — the equity tranche, or toxic waste — that absorbs the first dollar losses from an entire portfolio. The enormous scale of the CDO industry suggests that somebody's been buying a lot of toxic waste. Who is it?

It's the hedge funds. And the entire industry is dancing to their tune.

Hedge Funds

Hedge funds are unregulated investment vehicles that cater to institutions and wealthy individuals and promise extraordinary returns. There are few limits on how they invest, what kind of risks they take and how much leverage they use. The top performers truly have achieved spectacular results, some over very long periods. But as the field has gotten ever more crowded, average returns have been decidedly lackluster, especially given the industry's outsized pay packages. As of mid-2007, hedge funds deployed an estimated \$2 trillion to \$2.5 trillion of equity capital and much higher economic capital due to their aggressive use of leverage.

A large subsegment of hedge funds now concentrates in CDOs and credit default swaps. These hedge funds account for about 60 percent of all trading in credit default swaps — that's a \$45 trillion market — and for about a third of CDO trading. All the evidence is that they are especially concentrated in the riskiest classes of credit-related products.

The appetite of hedge funds for the riskiest positions has made them a major source of liquidity in the CDO and credit default swap markets. Their willingness to employ leverage to maximize those positions amplifies their impact. Their persistent demand for higher-yield products is pushing the industry up the risk ladder into CDOs constructed from second-lien loans, bridge

Summary: THE TRILLION DOLLAR MELTDOWN

financing, private equity and other less liquid assets, often with minimal protections for higher-tier buyers.

These are very risky investments that can turn very quickly. If only a single CDO was in trouble, a hedge fund would probably have no problem stumping up the required extra margin. But since CDOs are often representative of an asset type, a raft of similar CDOs is likely to be experiencing similar problems. And now we're into a replay of the June 2007 Bear Stearns subprime hedge funds' liquidity confrontation. The bank demands its cash, the hedge fund pleads straitened circumstances, the bank seizes assets and tries to sell them, and the doors blow off the market.

Ponzi Firms

"Ponzi" firms must borrow to meet all their interest payments, so their debt burden continuously increases. At some point, a disruptive event occurs, like the collapse of the United Airlines LBO in 1989 or the Russian bond default in 1998, and markets abruptly re-price — the further along in the cycle, the more violent the re-pricing.

The total of global financial assets, which essentially are claims on GDP, was about the same as global GDP in the early 1980s. At the end of 2005, according to a recent International Monetary Fund analysis, global financial assets were about 3.7 times as high as global GDP. In other words, outstanding financial claims not only cover this year's GDP, but the next several years' as well.

Financial derivatives, which represent claims on financial instruments, were a relatively rudimentary market in the 1980s. Their notional value by the end of 2005, however, was three times higher than the total of all financial instruments and more than 10 times higher than total global GDP. When those numbers are totted up for 2007, we undoubtedly will find that they have ratcheted up much higher still, with the upward curve tilting more toward the vertical.

Unstable Tower of Debt

In this class of instruments, a relatively small number of institutions, basically the global banks, investment banks and credit hedge funds, do most of the trading. In effect, they've built a huge Yertle the Turtle-like unstable tower of debt by selling it back and forth *among themselves*, booking profits all along the way. That is the definition of a Ponzi game. As long as a free-money regime forestalled defaults, the tower may have wobbled, but stayed erect. But small disturbances in any part of the structure could bring the whole tower down, and the seismic rumblings already in evidence portend disturbances that are very large.

The American financial sector today is far more powerful than it was in the 1970s. And to date, its response to the looming crisis has been, overwhelmingly, to downplay and to conceal. That is a path for turning a painful debacle into a decades-long tragedy. ●

Winners and Losers

Billion-dollar dividends to opportunistic takeover artists are just one wavelet in a long-term and, for many, an increasingly disturbing tidal shift in American society — a widening disparity of wealth and income not seen since the Gilded Age.

The argument about whether the past several decades have seen growing inequality in America was effectively closed by Federal Reserve Chairman Ben Bernanke in a wide-ranging speech delivered in February 2007. Reviewing all the evidence, Bernanke took the fact of growing inequality as settled and challenged economists to discover why.

Explanations of "why" disparity is growing include, variously, the declining real value of the minimum wage, the globalization of work and the decline of unionism, the widening dispersion of education and other skill differentiations within the labor force, and the effect of cheap computer power in enhancing the productivity of highly skilled people.

For most of the past decade, business and government have offered a depressing spectacle: The massive frauds of the Enrons and the WorldComs. The eager self-delusions and conscious deceits that underlay absurdly misrated CDOs. The shameless selling of the government. The monetary helium from the Federal Reserve that fed asset bubbles, fueled a bread-and-circuses consumer binge, floated Wall Streeters into the financial stratosphere and perhaps irrevocably debased the dollar.

A less apocalyptic reading is that we are witnessing the final days of another quarter-century political/ideological cycle — the last gaspings of the raw-market, Chicago-school brand of financial capitalism that moved into the vacuum created by the 1970s collapse of the Keynesian/liberal paradigm.

On the Cusp

Political cycles turn when an extended period of either conservative or liberal hegemony brings the baser, more self-seeking or barmiest elements to the fore. The market and regulatory reforms introduced by economic and monetary conservatives in the 1980s made a major contribution to the recovery of

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American competitiveness and economic energy in the 1980s and 1990s. But as the more unsavory impulses in the conservative understanding have asserted themselves, the country has been brought to the brink of financial, economic and, in politics, moral disaster. All the signs are that we are on the cusp of a turning of the cycle, much the same as in 1980.

Assuming we face our issues squarely and get through the next couple of years in much the same way we did in 1979–82, we can start addressing the detritus of knotty problems left over from the cycle's turn. ●

Recovering Balance

It is a canon of Chicago-school economics that government resource allocations always reduce productivity. As a blanket proposition, that's evidently wrong. The federal government lavishes a great deal of money on the semiconductor industry and the Internet, for example, and we're clearly much better off for it.

Since the beginning of the republic, public works investments — canals, railroads, highways, airports — have generally paid high returns. In the 19th century, a British parliamentary commission identified America's greater investment in public education as a major competitive advantage. Government spending, in short, is productive or not, depending on what it's spent on.

But there is a substantive truth behind the detestation of public spending. It is that any privileged industry — and public enterprises are prone to become privileged — will eventually fatten to the point where it becomes a drag on, or even a threat to, the health of the economy. But that's a general argument about privilege, whether it arises from tax subventions or some other source. The financial meltdown chronicled here was to a great extent the consequence of coddling our financial industry, fertilizing it with free money, propping it up with unusual tax advantages for fund partners and anointing it with fresh funds whenever it stumbled or scraped a knee.

The real premise of the Chicago-school argument for shrinking the public sector is the much shakier one that free markets always achieve the best outcomes. That claim, however, presupposes that economists can identify best outcomes.

No Perfect Markets

Some of the world's greatest economists have tackled the distribution problem and have produced many interesting ways of framing the issues. But no one has come up with much that is of practical use. The data are

intractable, analytic results are often self-contradictory, and even believers in the quest concede that the models make sense only in perfect markets, which are not places where real people live.

The fallback among free-market economists, therefore, is usually to adopt a total output measure, such as GDP growth or national productivity, as a best-outcome proxy. But that reduces competition among social systems to the principle that the country with the most toys wins, which is ridiculous.

France, for example, has had lower economic growth than the United States for a number of years, even though hourly output per worker is roughly the same — it was a hair behind America's in the last competitive survey and was a hair ahead in the previous one. The French middle-class citizens have smaller houses and cars than their American peers, but better diets, considerably more leisure time and much more economic security, while the distance between the top and the middle is not nearly so wide as here.

France is hardly a perfect country. Its unions and public sectors seem much too privileged, and racial issues are becoming much more intractable. But all in all, a lot of Americans, especially those who are not at the top of the food chain, might think it's a pretty good trade.

The Other Direction

In other words, it comes down to taste as well as balance and judgment. The 1980s shift from a government-centric style of economic management toward a more market-driven one was a critical factor in the American economic recovery of the 1980s and 1990s. But the breadth of the current financial crash suggests that we've reached the point where it is market dogmatism that has become the problem, rather than the solution. And after a quarter-century run, it's time for the pendulum to swing in the other direction. ●

RECOMMENDED READING LIST

If you liked *The Trillion Dollar Meltdown*, you'll also like:

1. ***Biography of the Dollar*** by Craig Karmin To understand the dollar's current position it is important to understand how the dollar achieved its exalted status in the beginning. *WSJ* reporter Craig Karmin explains.
2. ***Greenspan's Bubbles*** by William A. Fleckenstein with Frederick Sheehan *MSN Money* columnist and hedge fund manager William Fleckenstein takes a critical look at Alan Greenspan's 19-year tenure as chair of the Fed.
3. ***Transparency*** by Warren Bennis, Daniel Goleman and James O'Toole Three essays look at this urgent issue and offer leaders practical advice on how to embrace transparency as a good thing, even if it's not an easy one.

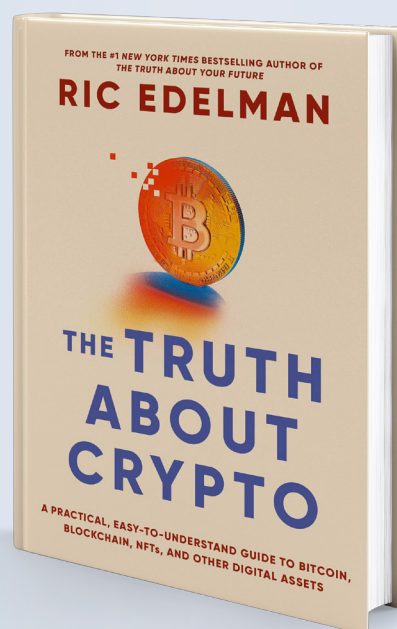
· Book 42 of 44 ·

The Truth About Crypto

Ric Edelman

BOOK SNAPS™

Zooming In On Your Next Read



The Truth About Crypto

A Practical, Easy-to-Understand Guide to Bitcoin, Blockchain, NFTs, and Other Digital Assets

By Ric Edelman

Ric Edelman, a New York Times best-selling author, has been providing financial advice to the public for 30 years and is a well-known, successful financial advisor. His television series, *The Truth About Money with Ric Edelman*, airs on Public Television stations across the country and his syndicated radio program can be heard from coast to coast.

The Newest Frontier in Investment Strategy

John Oliver, in 2018, described cryptocurrency as “everything you don’t understand about money combined with everything you don’t understand about computers.” While many believe that cryptocurrency will revolutionize commerce, many are unsure of what it is. According to Ric Edelman in *The Truth About Crypto*, the more someone understands about finance, the likelier it is that they will have difficulty understanding cryptocurrency. Nevertheless, more than 90% of the world’s banks are developing cryptocurrency and jobs in the field are growing exponentially.

To understand blockchain technology, it is important to understand ledgers. As Edelman explains, a ledger is used by people and businesses to record deposits and withdrawals. This forms the basis of a trust company where people are forced to trust that what they are told is true in order to participate. We live in a trust economy and use what is called a fiat currency. A blockchain, on the other hand, is a ledger in which all people can access the information at the same time, and no person can edit or delete it. This distributed record forms the basis of an authentication economy because all information can be authenticated instantly. No trust is required. This eliminates many middle men including trust attorneys and stock brokers, saving individuals and corporations thousands to millions of dollars.

In short, a block is like a single block or cell in an Excel spreadsheet. When the blocks are linked, they are called a block chain. If a block chain is used, buying a house could be near instantaneous if one block contains an individual’s information, another contains the deed to the house, and the third contains the buyer’s information. Besides the cost and time savings, block chains provide many benefits to individuals and businesses. According to Edelman, perhaps the greatest benefit of block chains is to those people who do not have bank accounts. Cryptocurrency can help them establish credit and receive and send money. Because of this, it is very beneficial for reducing poverty especially in places with less trustworthy banking systems.

How Do Blockchains Work

In a blockchain, any piece of data from a long document to a bank record is converted to a hash. The hash is “a string of computer code that represents the data.” If any of the code is changed, it creates a new hash that is then linked to the original.

The links together constitute what is called the single source of truth. These links are both “secure and unbreakable.”

Edelman compares a digital signature for a blockchain to the key to a car. It consists of both a private key and a public key. The private key is given to each individual user, and without it, a person cannot access their digital assets. This is not shared with anyone. A digital signature can be compared to an email account where the private key is the login credentials and the public key is the email address.

Since there is no single Bitcoin ledger, the ledger is distributed across all the nodes, or computers, on the network. Data on the nodes needs to be authenticated. People who authenticate data on the network earn a block reward. This block reward is paid in bitcoins. There is fierce competition for these bitcoins.

Edelman discusses two ways to authenticate data. The first is mining. Mining refers to the complex math equations required to decipher a block. This is also called proof of work. The second method is called Proof of Stake. With this system, people purchase coins, and each coin is like an entry in a raffle. The winner of a particular raffle wins the block reward.

Edelman then discusses the three ways digital assets can be stored. The first is in a hot wallet. This wallet is connected to the internet and could potentially be hacked. The second option is a cold wallet. This is essentially an encrypted flash drive where the wallet is stored. The downfall is that it can be time consuming to transfer coins in a cold wallet to a hot wallet where they can be used. A third option is a warm wallet. In this case, assets are kept in a hot wallet but can only be used per instructions by the owner. Finally, a person could purchase a fund rather than individual assets.

Different Types of Protocols

There are many different blockchains and blockchain currencies. Perhaps the most well known one is the Bitcoin computer network and the bitcoin asset which works on it. Some of these are valuable and worthwhile, and others are mere gimmicks according to Edelman. There are different ways to classify these protocols, but Edelman breaks them up into four different categories, describing each.

Base Layer Protocols: Developers create protocols, coins, and blockchains. In a simple analogy, a blockchain is a highway, the coins or tokens are the cars, and the protocol is the set of rules that govern the whole system.

Second Layer Protocols: Developers want to decentralize systems while adding security and scalability. One way they do this is by adding second layer protocols onto existing Base Layer Protocols. In this manner, “the base layer provides security and decentralization, while the secondary level provides speed and scale.”

Financial Products and Services: These are built on top of base layer and second layer protocols.

Non financial Products and Services: These two are built on base and secondary layer protocols and serve the needs of groups such as UNICEF and the World Food Programme.

Money, Currency, and Tokens

Edelman begins this section describing both money and currency and exploring whether digital assets qualify as either. Money has three qualities: store of value (maintains value over time,) unit of account (can be used to describe the value of things,) and medium of exchange (“facilitates the exchange of goods and services”). According to these criteria, bitcoin is money.

Edelman says, “currency is the physical representation of money.” According to most of the criteria, bitcoin is currency as it is durable (survives repeated use,) portable, divisible, uniform, and has a limited supply. Currency also has to have acceptability meaning that most people accept it in exchange for goods and services. Many but not all places accept bitcoin, so there is debate over its acceptability. As such, people have to decide for themselves whether they consider bitcoin currency.

He then moves on to discuss tokens. “Tokens are small digital representations of something intangible.” An example of a token is the token subway users used to use to ride the train. There are multiple different types of tokens available:

Utility Tokens: A start up company may earn money to create their products by selling tokens. These tokens represent a promise of a product once the product is manufactured. The risk is that the company could fold and no product will ever be made.

Security Tokens: These are “an online representation of a real, physical asset.” An example of this can be found in the real estate market. Since real estate is so expensive and illiquid, an owner of a building can sell tokens which each represent a share of the property. This could be done by owners of billion dollar office buildings as well as individual homeowners.

Governance Tokens: With governance tokens, people have a say in a blockchain. One token could equal one vote in key decisions.

Non-Fungible Tokens (NFTs): A dollar bill is fungible because one dollar bill is equal to any other dollar bill. Non-Fungible Tokens are not interchangeable. There are many examples of non-fungible tokens. Sports leagues have created trading cards; art has sold digital copies, and video games have created avatars.

Value of Bitcoin

Experts disagree over the value of bitcoin. Edelman asserts that bitcoin may have no intrinsic value, but that does not mean that it does not have a price. It is easy to find financially successful people who do not value bitcoin and who insist on staying away from it. Much of this is because they are basing their decisions on factors that do not apply to bitcoin because bitcoin does not have any revenues.

To determine the value of bitcoin, according to Edelman, we



... bitcoin may have no intrinsic value, but that does not mean that it does not have a price.”

have to look to other methods. One method attempts to determine how effective it is as money; another evaluates it based upon how fast it can switch hands, and a third values it based upon the number of users in a network. Dozens of more methods exist.

Some may question whether it is too late to purchase bitcoin. After all, its price has already risen 87,000,000%. Edelman addresses this concern stating that clearly this is not replicable, but it is still able to rise significantly. That does not mean there are no risks involved. Edelman asserts that digital assets could fail for any number of reasons including market manipulation, business or commercial failure of a product in the marketplace, technological obsolescence if newer and better technology is created, a decrease in consumer/inventory demand, regulatory intervention, advances in quantum computing that could allow the networks to be breached, rogue custodians who do not protect assets, lost passwords, compromised wallets, hijacked SIM cards, typos that accidentally get rid of all acquired assets, as well as everyday scams.

Edelman begins his section on investments discussing Modern Portfolio Theory. According to this theory, adding a non-correlated risky asset to a primary risky asset in a portfolio reduces the overall risk. Likewise, adding a third even riskier asset that is not correlated to the other two can reduce the overall risk at a particular time but improve its overall returns. Bitcoin is risky and not very closely correlated with other more traditional investments. As such, Edelman says, “adding digital assets to your portfolio can help you obtain higher returns while actually lowering your investment risk.”

Traditionally, assets could be divided between cash, stocks, bonds, and real estate. Digital assets now make up a fifth category. Edelman states that with stocks, a large investment (60%-100%) is needed to make it worth it. Digital assets are so risky, however, that a small percentage is optimal. The percentage is determined by both a person's knowledge of digital assets and their level of risk, but 1% is sufficient for growth. A 2018 Yale study suggests that even if an investor predicts “bitcoin will outperform other asset classes by 100% a year, you should invest only 6.1% of your portfolio in bitcoin.”

Once an investor purchases digital assets, they must determine how to manage them. As with more traditional investments, Edelman does not recommend market timing (buying and selling in the short term depending on prices.) A longer term investment yields better results. If a person wants to minimize the risk of investing all their money in one day, he explains the benefits of dollar cost averaging, or taking the total amount to be invested and investing it at regular intervals instead of all

at one time. Edelman reminds investors that it is important to occasionally rebalance assets to ensure that the percentages remain the same.

Regulating, Taxation, and Compliance

There are four major issues when it comes to regulating digital assets. Edelman lists these as jurisdiction, terminology, anonymity, and dispute resolution. Regulators have to devise answers to these issues. There are three different approaches countries take. Encouraging countries allow digital assets to flourish; permissive countries refrain from interfering too much until they figure out what to do, and strict countries ban certain assets or are hostile to people who own such assets.

Digital assets are property. Edelman says, “[l]ong-standing tax principles involving property apply to this new asset class.” The IRS has increased its enforcement efforts. There are three stages of the digital asset ownership life cycle. These are purchasing, holding, and disposing. The rules governing taxes are determined by multiple different factors, and the laws change, so Edelman reminds the reader that it is important for any investor to know the applicable tax laws for their transactions. Investors need to keep detailed records and remember that rules do not always apply to digital assets in the same ways they do to other assets. Rules do apply, however.

There is a lot to learn about cryptocurrency in regards to what it is, how to purchase it, how to determine its tax rate, and how to regulate it. Ric Edelman's book provides a basic introduction for the interested investor. In addition to the overview, the book also contains numerous tables listing options and resources to help the reader make wise decisions in regards to whether and how to invest their money in digital assets. Because laws and options are constantly changing, it is important for investors to seek the most up to date information and to find trusted professionals to help them.

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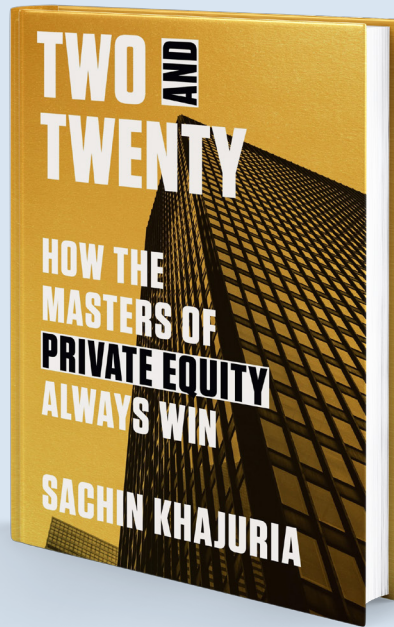
· Book 43 of 44 ·

Two and Twenty

Sachin Khajuria

Book Snaps™

In-depth reviews of best-selling business books.



A Book Review by Soundview

Thriving Among The World's Hungriest Dealmakers

In *Two and Twenty: How the Masters of Private Equity Always Win*, author Sachin Khajuria attempts to open the door to this industry that holds the possibility of creating massive wealth for select individuals while helping struggling companies succeed. This is an industry that despite its impact on economic systems is largely misunderstood or not understood by the general public, and with his book, Khajuria hopes to rectify this ignorance and misunderstanding. The private equity business has the potential to provide massive benefits for companies and communities through the businesses private equity firms are able to help and usually save. As with any investing, private equity investments are not foolproof, but Khajuria maintains that through a unique combination of factors, most noticeably the diligence and intelligence of key members of the game, private equity firms very often have high returns and rates of success. Khajuria writes of his intention for his book, "I have worked in this industry for twenty-five years, first as an investment banker and then as an investor at one of the major firms at the partner level. I am hugely supportive of this industry and invest actively in it across the major firms - from my own account. I am your insider, but I am also independent. I'm not interested in spin or corporate talk. I call it like it is."

How It Works

Khajuria initiates his reader into the world of 2008 when the economic systems that so many people relied on were breaking. He refers throughout his book to a private equity firm that he simply calls "the Firm." The Firm's investment community is conducting their weekly meeting as the Founder urges all members to get ready for Europe to fall into financial chaos shortly just like the United States has. This will be the Firm's time to act. Decisions the Firm has to make are difficult, but they are made less risky by the massive amount of information the Firm gleans about the situation concerning potential investments as well as on the massive level of expertise and finesses members at all levels of the Firm embody. Unlike other investors, private equity firms do not merely infuse

Two and Twenty

How the Masters of Private Equity Always Win

By Sachin Khajuria

Sachin Khajuria is a former partner at Apollo, one of the world's largest alternative asset management firms, and is also an investor in funds managed by Blackstone and Carlyle, among other investment firms. He has twenty-five years of investment and finance experience. Sachin holds two degrees in economics with honors from the University of Cambridge.

money into an entity. Rather, they infuse massive amounts of money and then back up that money by working themselves to improve the entity at hand. It is their job to know the business, so they can successfully make the decisions necessary to make the business more successful and make themselves and their investors massive amounts of money in the process.

As Khajuria states, the intent is to “buy the target, control it, improve it, and sell it for a profit.” Khajuria insists that it is this symbiotic relationship that makes private equity work. When the company makes money, the Firm makes money. The success of both the Firm and the entity is dependent upon each other. He maintains that private equity is essential, in part, because the life spans of people are increasing, and because of this, healthy pension entitlements are necessary for retirees. The same is true for college endowments: growth is necessary to help generations that come after. He sees private equity as necessary for helping these industries raise the money they need, and as such for helping average Americans achieve their financial goals: “And so teachers, firefighters, healthcare workers, and other employees who are part of retirement systems depend on private equity to make the math of their pensions work. They need places like the Firm.”

In general, private equity firms will purchase enough of a company to have either controlling interest or at least considerable influence. Once this is in place, members of the Firm begin acting within the enterprise to increase value in the company. The Firm is not interested in the long term. They look to make improvements necessary in the company in order to increase its value. At that point, they sell off their portion of the company, to the financial benefit of all involved. The endgame is always to sell. This crystallization can take numerous forms. It “can be the sale (partial or full) to a large corporation or another private equity fund, or a listing (or relisting) on the stock market, after which point the private equity fund would ‘sell down’; its stock in an orderly fashion over a period of months.” This is possible because of the Firm’s “deep understanding of both the financial side and the operating side of a situation.” This requires the Firm to have a solid understanding of management as it is management team members that they rely on for the day to day operations. For this reason, the Firm must have a clear understanding of the job management is doing as well as what their goals are for the investment. In short, they do not just invest money. They invest their expertise and business acumen as well.

The Structure of Private Equity

Khajuria goes on to explain the basic pyramid structure of a private equity firm. This pyramid has three levels: “the analytic base, the middle layer, and the senior set, called the partners or managing directors, who are the individuals most directly responsible to investors for the firm’s investment performance and conduct.” Members of the base typically spend about five years on the lowest rung. Khajuria describes the middle rung “as the day-to-day deal quarterbacks.” They manage quality control on those below them whose job is to fully understand “the business model and the finances of an investment.” Those at the middle level are generally promoted from the bottom of the pyramid, and they work closely with both those below

them and above them. Those at the top of the pyramid are “the partners who run the investment activities of their firm. They find deals and lead the execution of these opportunities.” Khajuria describes them as being the elite who “bear the biggest burden for success or failure.” They also benefit the most financially from the firm’s payment structure.

Promotion is not guaranteed by any means: it must be earned and there must be a position open. Firms generally promote more than they rely on lateral hires although this is changing to a slight degree. Of the teams working on deals, Khajuria says, “At every point, the team is obsessed with protecting the investment against capital loss and increasing the company’s value to be in a position to capture more profit on the deal at the exit.” The team’s goal is to win with every investment rather than to back a large number and hope some succeed. The teams are generally both small and tight knit although a member of the Firm could be working on multiple different teams at one time.

Khajuria turns his attention to how firms work. Oftentimes firms have presence around the world and in many different industries. In a fictional firm Khajuria describes, the mission is explained as being one that serves retirement systems while benefiting both the retirees and shareholders. In Khajuria’s opinion, it is a genuine intent. Firms often are decentralized and rely on checks and balances. He describes the fictional Firm as feeling more tight-knit than corporate. Still, power is concentrated. “The magnitude of investment decisions that rest on perhaps a few dozen sets of smart shoulders is immense. As the assets under management grow, the responsibility these individuals have grows too.” While members of the Firm mingle between levels and those at the top are happy to help those who work under them, there is no real equality. Those at the top hold the money. Those at the top have amassed so much wealth that they do not have to work any longer. They are there because they want to be. People at the Firm are loath to waste time, and they prize face to face communication over digital communication. Responsibility is given to those who can handle it, and there is so much work and pressure that wasting time is not really an option. Those at the top of the pyramid hold most of the power over what happens. This helps a few people amass large sums of wealth, and it is those at the top who “have profound influence on increasingly broad swaths of the economy.” These people generally stay out of the limelight. Because private equity firms hold so much influence, it is imperative that they act with ethics and transparency and that they rely on sound judgment.

Traits of Those Successful in Private Equity

Khajuria turns his attention next on the particular characteristics common to private equity team members. Private equity team members invest massive amounts of money into companies, but they also take a sense of ownership over the companies. They make the tough decisions and spend the time researching every aspect of the company in order to turn struggling companies around. These team members compete for a small number of positions that hold massive amounts of responsibility and have



... one of the factors that sets private equity apart from other financial industries is that those in private equity only make money when their investments make money.”

the potential to both create and lose tremendous amounts of wealth. When making tough decisions, Khajuria says, ‘In order to make any kind of move, whether in the form of the requested cash infusion or otherwise, we first have to look the deal in the mirror and report back to the Founder exactly what we see. We look squarely at the blemishes and scars on the investment and ask honestly, what, if anything, still looks good enough to salvage.’”

Khajuria maintains throughout the book that one of the factors that sets private equity apart from other financial industries is that those in private equity only make money when their investments make money. This gives them tremendous incentive to succeed. On top of that, however, they also must be ruthless in their analyses. They have an “iron grip of the owner mentality” because they make their money when they exit the deal and the company is sold. As Khajuria writes, “You eat what you cook. The hardest work often happens after you have closed a deal. This kind of discipline, to accept that you must stick with investments without an easy option to separate, can act as a clear litmus test for commitment and determination.” This sometimes requires years of sacrifice on the part of the team members. He explains that in troubled situations that arise from investments by the Firm, team members do not try to cover up what has happened. They admit to their mistakes, but there are also consequences should a deal not be as lucrative as expected.

Another aspect of private equity is chaos. Khajuria says, “This belief [that chaos can lead to profit] is core for the master of private equity. They Love a mess to analyze, some disruption to decipher, or an economic firefight to bring to heal... They actively seek dislocation.” Because private equity team members put themselves in difficult situations that others will not touch means that they have to be attracted to complexity. While most people seek out quick fixes, private equity team members avoid simple answers because they know that difficult situations can provide the best opportunity for success. Because of this, Khajuria says, “The attraction to complexity is one of the most important mental frameworks and identifiers in private equity.” Still, he insists that private equity team members are not just drawn to complexity because of the possibility of enormous returns. Rather, they view risk differently. Because they do so much work and research to understand the whole system at play within a company, they are able to understand which risks should be taken because they only make decisions that they believe are achievable.

In addition to these above traits, private equity members must be highly competitive. While members of the same organization want their firm to make money, some internal competition between private equity teams can benefit everybody when it prompts team members to work even harder. A will to win is necessary for success. In addition, Khajuria claims that team

members must have some level of desperation. They must be insistent on winning and in creating inroads to new sectors and new ways to make money. While desperation is often seen as a negative, Khajuria describes it as “not just the hunger to succeed but also the primordial need to win.”

What Sets Private Equity Apart

Khajuria states that many people believe that “Private equity investors target vulnerable companies to buy, saddle them with debt, cut costs to the bone, and sell for a quick profit.” The myth goes on to say that any improvements to the business are secondary because all private equity cares about is selling for profit. He maintains that this is not the case. One reason for this is that private equity understands that they cannot sell an investment to others if the company is not in good standing. This does not mean, however, that the exit is not of primary concern. They need “a single-minded focus on the outcome,” and everyone on the private equity team needs to understand just how much money they can make if they sell at the level they want to. This requires the ability to constantly reassess and to pivot when necessary. Large entities generally do not have this ability to pivot with such speed.

Khajuria discusses the industry in the wake of Covid-19 when “certain members of the administration appear to have the private equity industry in their sights.” He describes how the Firm’s Founder had started to receive some negative publicity. As a response, the Firm began to highlight the benefits they accrued for pension funds. The Founder also explains that for the risk involved, the unit of return is better than they can get elsewhere. He is able to win over some of his detractors with his response to the negative publicity. What stands out to Khajuria is the fact that the Founder chose to respond to critics rather than to react to them. He did not skirt responsibility. Rather, he explained the situation and explained how they were going to grow from the lessons learned from it. Khajuria believes this speaks to the imperative of temperament in a private equity professional. Most private equity decisions are made without the influence of emotion, and this is what sets them apart from other areas of business.

In private equity, success is said to be binary. You either win or you do not. Because of this, team members must need to be highly motivated to win, and they must be able to put making money on deals as the highest priority. Khajuria believes that successful deals validate the hard work put in over many years especially as he believes the industry is now pivotal for the success of retirement pensions. Private Equity understands that they carry the huge burden of stewarding other people’s money, and they know they can not rely on excuses when they

fail. They are committed to transparency. Khajuria believes that there is no room for ego in these businesses and that this culture where everybody is intensely invested in the success of deals helps promote a culture of hunger. Negotiation plays a large role in this because team members will always be asking themselves if the current route of a plan is good enough or if it can be improved. This personal investment in the company is what makes private equity different.

The Library

The library is what Khajuria refers to as the massive amount of information and understanding private equity has over many different companies and industries due to the breadth of their investments as well as the massive amount of time and effort they put into understanding the businesses they work with in order to help them turn a profit. Because the information is not always public, private equity firms must at times create silos so as to avoid conflicts of interest. Usually, however, the most senior members of the private equity firms will be above many of these silos and can use this vantage point to determine when these silos should be maintained and when they should not.

Khajuria explains that firms follow non-disclosure agreements and shred files when required to do so and do what is necessary to maintain the confidentiality that they are tasked with maintaining. He goes on to say, however, that human beings cannot erase what it is they know about companies and industries. He claims that this gives team members a deep understanding of the macroeconomy, and this can provide a distinct advantage. This library of knowledge and intelligence only gets bigger as the Firm gets bigger and develops even more experience, ultimately giving the Firm even more of an advantage over others.

Throughout his book, Khajuria extols the virtues of the private equity system. He sees the system as being able to combine a work ethic second to none with a driving desire to win and an insistence on massive research and deep understanding of the workings of companies to make money not only for themselves but for others as well. He maintains that pension systems are reliant on the smooth operations of private equity. He also insists that private equity firms are also interested in helping those around them. While private equity firms must make the tough decisions, they insist that what is left is a stronger company.

Sachin Khajuria maintains that while private equity firms are committed to making massive amounts of money, they are also interested in bettering the world around them. All of the points mentioned above are fleshed out in his book as he gives examples of fictional and masked organizations and companies that illustrate how these principles are at play in the actual world of private equity. While Khajuria is adamantly committed to the idea that private equity is a benefit to the world, he backs up his statements and propositions with anecdotes and analysis in an attempt to prove the claims he makes about the industry, its benefits to society, and its key players.

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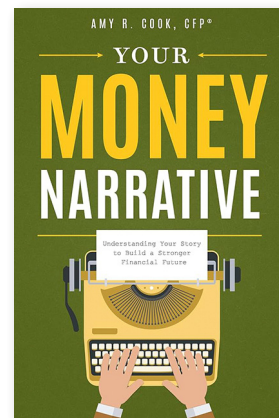
Your Money Narrative

Amy R. Cook

Your Money Narrative

Understanding Your Story to Build
a Stronger Financial Future

by **Amy R. Cook**



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THE SUMMARY IN BRIEF

The story our finances tell us is no different than the plot-lines of our personal lives. The way we manage our money today decides the type of future that's waiting for us tomorrow.

The book *Your Money Narrative: Understanding Your Story to Build a Stronger Financial Future* deftly shows us the many ways that people use and abuse money. Rather than preaching about the dos and don'ts of the financial world, we learn through the interesting stories of young and old, rich and poor, people who are smart with money, and those who aren't.

Author Amy R. Cook simplifies complex financial jargon and delivers wisdom about money we can use throughout our lives. She helps us understand our personal financial narrative, laying out a creative roadmap toward helping us build a stronger future along the way.

IN THIS SUMMARY, YOU WILL LEARN:

- How to analyze your current financial story.
- How to determine your money narrative.
- How to manage your money for a stronger future.
- How to take the emotion out of finances to save and invest smartly.

Introduction: We All Have a Money Narrative

I loved cycling as a kid. At five, I entered a bike race of two and won second place, which came with a trophy. But even at five, I knew that second place in a race of two only meant one thing: there was one winner and one loser, and I lost. My dad told me that I had lost because she had a far lighter and “better” bike than I did and that he couldn’t afford to buy me a bike like that. This experience formed my first money narrative. A couple of years later, my parents hit hard financial times, and as I watched my dad’s incredible stress, I decided that money was again the missing component. Another money narrative.

But my money narrative will be different from yours simply because we all have unique stories and have experienced life differently. This book is a culmination of short stories based on fictional characters with relatable dilemmas you may identify with. You may discover money narratives that changed your life in a positive way or uncover stories that need an update. Either way, by pulling the curtain back and examining your own money narratives, you can determine if they’re aligned with your financial goals and the legacy you want to leave behind.

Chapter 1: The Real Estate Pact

Real estate/home ownership can be a valuable component of your overall investment portfolio. A fixed-rate mortgage provides a consistent payment with the debt decreasing over time, which you will eventually pay off. There are also tax benefits associated with home ownership. If you are conflicted about whether you’re ready to purchase a home, it may be beneficial to consult a financial professional for assistance with a rent-versus-own analysis. If purchasing a home is not feasible at the moment, you can develop a plan to gradually save for a down payment to prepare for the future. Ask yourself:

- Am I planning a large purchase or investment in the next five years?
- If so, have I thought about some of the legal and financial aspects of the story?
- Are there gaps that I’m unclear on that need more research?

Discuss and create a plan for large purchases (house or rental property) before you start the process. Do your due

diligence on the professionals hired and the overall process, including additional unexpected expenses. Ensure you are adequately prepared financially. If not, put a plan in place with a timeline to achieve the goal.

Chapter 2: The Teenage Entrepreneur

Whether you enjoy discussing financial topics or avoid them as much as possible, money plays a part in our lives. If we spend all our money, we end up broke. If we save all our money, we might miss out on things we enjoy doing. But if we take the emotion out of financial topics and put a plan in place that directs our money where to go, we can help our kids set up similar habits so that they can do the same. Ask yourself:

- Do I have basic money management conversations with your kids?
- Am I including them in parts of household finances where they are involved, such as vacations, college planning, etc.?
- Have I asked my financial advisor to talk with my teen/preteen about financial planning basics when they show interest?

Talk to your kids about money and involve them in financial decision-making in areas that involve them. It could be for a family night out or saving up for something. Consider playing age-appropriate board games that involve careers and money and correlate it to real life or people they know. Encourage them to establish their own bank/savings account, list goals, and monitor them together.

Chapter 3: Just Getting Started

If you’re just getting started with your financial planning process, begin with paying off any outstanding credit card debt to free up additional cash flow for investing in other things. Once you pay off your debt, it’s time to establish an emergency fund that can get your family’s basic expenses covered for at least three months. With your debt now cleared and an emergency fund established, let’s say you now want to buy a house in three years.

The first step? Establish the dollar amounts you’ll need to fund your monthly goals. Based on that, make a road map toward reaching your home-buying goal. This could include getting a second part-time job, cutting down on dining out, groceries, travel, etc. Some expenses to review

An initial overall review can feel like a big “to-do” list, but it becomes much more manageable when it is broken down into smaller action items.

include your cell phone bill, cable bill, internet, automobile review, and credit monitoring.

Look for employee benefits you might be unaware of, such as RSUs (restricted stock units), NSOs (nonqualified stock options), and ESPPs (employee stock purchase programs). Another element of financial planning to pay attention to is insurance planning. Adequate coverage can protect you, your loved ones, and your assets against unforeseen circumstances. Review insurance types such as auto insurance, renter's insurance, homeowners' insurance, life insurance, and disability insurance. Finally, work with a financial advisor for investment planning. This could include tax planning, education planning, estate planning, and more.

An initial overall review can feel like a big “to-do” list, but it becomes much more manageable when it is broken down into smaller action items. The best approach toward this process would be to hire a qualified financial advisor. This step can add value to this process as your planner can serve as an advocate and guide you as you work toward your planning goals.

Chapter 4: The Enlightened Entrepreneur

Financial planning always comes down to the same three variables: what we spend, what we earn, and how much we save. When the numbers don't add up, we must decrease or increase one of those variables.

When you're in the early stages of building a business, it's easy to get lost in the growth of expanding your clientele. However, let's take a step back and look at some of the core items you need to have established if you want to maintain and protect what you are working hard to build.

Research and identify additional expenses, responsibilities, and opportunities before embarking on a new business venture. Don't eliminate the opportunity cost and the value of your time spent on the business when reviewing your numbers.

Regularly review your numbers (if you're already in business)

and seek assistance and guidance as needed to identify gaps and opportunities. Recognize your strengths and weaknesses as a business owner so that you can add support as you grow in areas that can be delegated. Most importantly, separate business and personal bank accounts and credit lines for ease of planning and transparency. Don't be afraid to seek help with business planning. There are many additional considerations, and a good financial team can make all the difference in how you manage revenue and grow. Finally, remember to add a benefits package for yourself for an extended period of time. If cash flow consistently doesn't allow for this, an evaluation and deadline should be in place to continue growing the business or move on to something different.

Chapter 5: The Sandwich Generation

College planning and caring for elderly parents will impact the majority of people at some point in their lives. But when we put our own financial health in jeopardy to do this, we aren't doing our loved ones any favors. If, for example, you pay for a pricey private school you can't afford, it will create additional stress and future financial problems for your household that will affect the entire family negatively.

Much in the same way we're told to put our oxygen masks on before our child's on an airplane, it's a good idea to put ourselves first financially. Like other financial planning topics, the earlier we address the goal and create a plan, the better.

Ask yourself, “Am I regularly reviewing my personal financial plan to ensure I'm on the right track for my goals?” “Are other expenses potentially putting my financial future in jeopardy?” “Are there areas where emotions may be taking over logic with my financial decisions?”

Have conversations with your partner/family members to express concern without judgment. Don't ignore a problem that could become a bigger one over time. Instead of panicking about a potential situation, focus on gathering all the facts and options. Write down a “to-do” list to research costs for all options versus guess estimates. Seek professional guidance for assistance if necessary.

Chapter 6: The Broke Millionaire

For some people, when income continues to increase lifestyle expenses rise at a greater pace while dollars disappear. This likely has more to do with overall habits than the need for more money. The stress and angst of living like that are not worth sacrificing your peace of mind and living within your means. Although letting go might initially seem like surrender, it can be empowering to reflect and assess your situation. It can provide a valuable reset, enabling you to position yourself for greater growth than staying on your current path.

Review your income, expenses, and cash flow one to two times per year to monitor and update changes. Don't incur additional debt to keep up with increasing expenses. Instead, consider applying variable bonuses and "extra" income towards goals versus increasing expenses. Quit counting on discretionary bonuses and income for fixed expenses and never avoid addressing the situation if you feel overwhelmed and stressed out. There may be some simple adjustments to shift things in a positive direction. Consider additional guidance if you need help analyzing your overall picture.

Chapter 7: Lessons In Collections

We all have our unique interests and things that bring us joy. Some of these things are free, and others can be more costly. This topic isn't about hobbies or interests. Regardless of what your hobby is, it is about how you feel about it. Some people spend money they don't have on things they don't necessarily need, and that is a different story. If you are on track to meet your financial goals and are funding the financial non-negotiables, you have the freedom to allocate and spend money on whatever you want – minus the guilt.

Don't live in guilt for no reason and don't avoid financial planning because you think you will have to give up things you enjoy. Instead, consider establishing a separate account for hobbies, travel, or whatever you want after you have allocated established percentages into the non-negotiable accounts. Talk with your spouse about interests, passions, and hobbies, and write it down so you are on the same page and in agreement. Finally, review your financial plan and goals annually and revise if necessary.

Chapter 8: Dilemma in Divorce

I am a proponent of proactive planning, and divorce is no exception. If you feel divorce may be in your future, take

action now. Let's face it: divorce or the possibility of divorce is not an easy or pleasant thing to think about, let alone prepare for. It might be tempting to ignore it as long as possible, but self-care is one of the only things we can control, and it's especially important when we are going through major life changes and challenges. We've all been presented with ideas for how we can better take care of ourselves. However, we are often directed to yoga, meditation, therapy, etc. Financial organization should be added to that list because it's an important component of our overall health.

Have frequent household financial conversations with your spouse. Plan for the best-case scenario but be prepared for other possibilities. Take action, organize your financial picture, and seek professional guidance if necessary. Don't assume your partner has everything handled and never ignore warning signs that things may be headed downhill.

Chapter 9: An Empty Bucket

Financial planning is unique for everyone, and it is heavily dependent on what stage of life you are in, your habits, and discipline levels. For instance, some people can have a credit card that they religiously pay off every month, racking up points as they go along. And others need to hide their credit card until they build better habits. Financial planning is not a one-size-fits-all process. There are fundamentals that we all need to have in place, which include an emergency fund, proper insurance coverages and investment vehicles, and an estate plan.

Ask yourself: Are there gaps in my financial plan or with those who are close to you (i.e. parents)? If there are big gaps between where you are and where you want to be, bigger shifts and new habits may be necessary. Start a conversation with your partner or loved ones and ask questions. If they do not want to engage, at least you tried. Think about your top three financial concerns right now and write down actions you can take this week to gather more information and take action. Don't hesitate to address topics that are keeping you up at night. It may be easier than you think to explore solutions and positive changes.

Chapter 10: The Unexpected Widow

My personal experience with my dad's passing sparked my interest in learning as much as I could about financial planning, which evolved into a passion for helping others do the same. The thought of losing a loved one or the idea

Periodic reviews are a critical part of portfolio maintenance and are necessary to address unsystematic risks that can be managed.

of our own death can understandably be a topic we prefer to avoid. As Benjamin Franklin famously said, “Nothing is certain, except death and taxes.”

So, have a conversation with your spouse and make sure you are both “in the know” with your household expenses and financial accounts. Don’t assume that your partner knows how to manage things without conversation and review. Put together a financial organization binder and review together. In addition to you and your partner knowing the location of the binder, share the location with an additional trusted friend or family member. The binder may take a few hours to organize but the benefits will be rewarding – a peace of mind in the present and a priceless gift to leave behind for your loved ones.

Chapter 11: Life-Changing Windfall

Whether you work for a startup, a publicly traded company, a non-publicly traded company or you are a business owner, diversification is an important component of your investment plan. As certain asset classes grow or decrease more than others, you may become overweighted or under-weighted over time. Periodic reviews are a critical part of portfolio maintenance and are necessary to address unsystematic risks that can be managed. Investing carries systematic/market risk that is generally unavoidable, but investing through multiple vehicles, industries, and companies can mitigate risks in your overall strategy.

Don’t ignore company benefits such as stock, especially if it is a large percentage of your net worth. Don’t allow concentrated risk to grow and ignore reviewing your strategy. Don’t be afraid to ask questions. Contact your HR department for clarification on any language in your contract that is unclear or confusing. Review your investment and asset allocation regularly and rebalance as necessary. Take the emotion out of highly concentrated positions and focus on your short- and long-term goals. Finally, diversify your investments and have an outside professional review your strategy for feedback.

Chapter 12: The Family Business

Family businesses and small businesses are more likely to ignore succession planning. It may be because they do not have someone to sell the business to, they plan to work forever, or they think there is no significant value attached to the business. But the value of a robust small business can turn into a nice stream of income in retirement if a plan is in place.

Additionally, when hiring others who are solo practitioners and a part of your financial team, ask them what their succession plan is. There are many CPAs, financial advisors, and attorneys who operate as solo practitioners. There is nothing wrong with this, but it is important for you to know what happens if something unforeseen happens to them. For instance, who will step in to manage things in the process, or what will happen to important hard copy documents, etc?

Make sure you do proactive business planning yearly and include debt or disability and succession planning in the long-term picture. Have conversations with family members who work for you if you are considering them as your potential succession plan to ensure everyone is on the same page. Research and hire help if you need it; there are professionals who are trained in this, and many specialize in specific industries. Once you have a succession plan in place, prepare legal documentation or agreements to ensure your wishes and avoid potential conflict.

Chapter 13: A Tale of Two Sisters

Two sisters (let’s call them Ella and Charlotte) received a handsome inheritance. Ella had the good fortune of spending time with her grandfather who shared knowledge that she made good use of and applied to her own life. She also had a natural interest in financial topics. Charlotte, on the other hand, wasn’t very keen on retaining her wealth. Before receiving her share of the inheritance, Charlotte would often take Ella’s help in managing her debts.

Charlotte’s spending habits worried Ella. Although Charlotte had a great opportunity for guidance through the process, she didn’t see the value in it at that time in her

life. But she's still young and hopefully, she'll choose to turn it around for herself and her relationship with her sister. If not, Ella may become resentful if her sister continually asks to borrow money.

We all have a choice over our financial decisions and the legacies we want to leave behind. It won't necessarily happen overnight, but to make positive changes, we must be aware of the financial narratives that might be sabotaging our goals and work to improve them.

Be aware and question financial beliefs that feel natural but are attached to negative emotions that aren't healthy for you or your family. Incorporate any inheritance money into your overall plan after you receive it fully. Don't treat inheritance money like it's "different money" or "not your money." Once you receive an inheritance, it is yours and should be treated like your own money.

Chapter 14: The Importance of Having the Right Team

Whether you are just starting out or are financially savvy, a financial advisor can be a valuable addition to your team to help navigate the ever-changing environment of options and resources.

I recommend interviewing two or three advisors before making a decision. Choose someone you trust and who is willing to spend time explaining things to ensure you are comfortable with the process and decisions you are making. Your financial team serves as an umbrella over your financial picture; as your picture evolves, your team will likely grow too. When you are getting started, you may have a banker and an insurance agent. As the complexity of your plan grows, you can build your team with a tax professional, financial planner, investment advisor, and estate-planning attorney to optimize your growth over time. Here are a few questions to ask a potential Financial Planner:

- How are you registered (investment advisor representative, broker, insurance agent)?
- Will you have a fiduciary duty to me?
- What licensing and professional designations do you hold? What is your investment philosophy? Are there any limitations to the investment options you have access to?
- What services do you offer, and do you engage in comprehensive financial planning? Do you help implement

plan recommendations?

- How are you paid for your services?
- How many clients do you have, and what type of clients do you typically work with?
- How often will we meet or review? Will this be in person, via Zoom, or by phone? Will I be meeting with you or other members of your team?
- If something happens to you, who will manage my accounts?

Conclusion: Your Money Narrative

As you reflect on your own money narrative, consider some of the following questions along with knowing the "why" behind your answers: What is your earliest memory of money? When you were young, were financial topics openly discussed or not discussed at all? Is your money style more aligned with one parent versus the other? Have you ever made a financial decision based on outcomes you witnessed growing up? Do you fear not having enough money? What is the best (and worst) financial decision you've ever made? What is your number one financial goal right now?

I hope this book will spark some great conversations and thoughts around your own money narratives. I wish you the best of luck with your continued financial planning and discovering your own money narrative!



Amy R. Cook's arrival in the financial industry was a serendipitous chain of events that started with her own money narrative and transformed into a success story. While working in the mortgage business at the start of her career, she was exposed to many financial dilemmas and noticed a reactive approach to financial decision-making narrative that runs through our minds. Since then, she has aimed to simplify the process of financial decisions and planning to help her clients reach their goals. Amy is a CFP® and has a master's degree in personal financial planning. She utilizes her education and experience to help clients across all industries and in all stages of life.

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