This is Not Your Parents' Retirement

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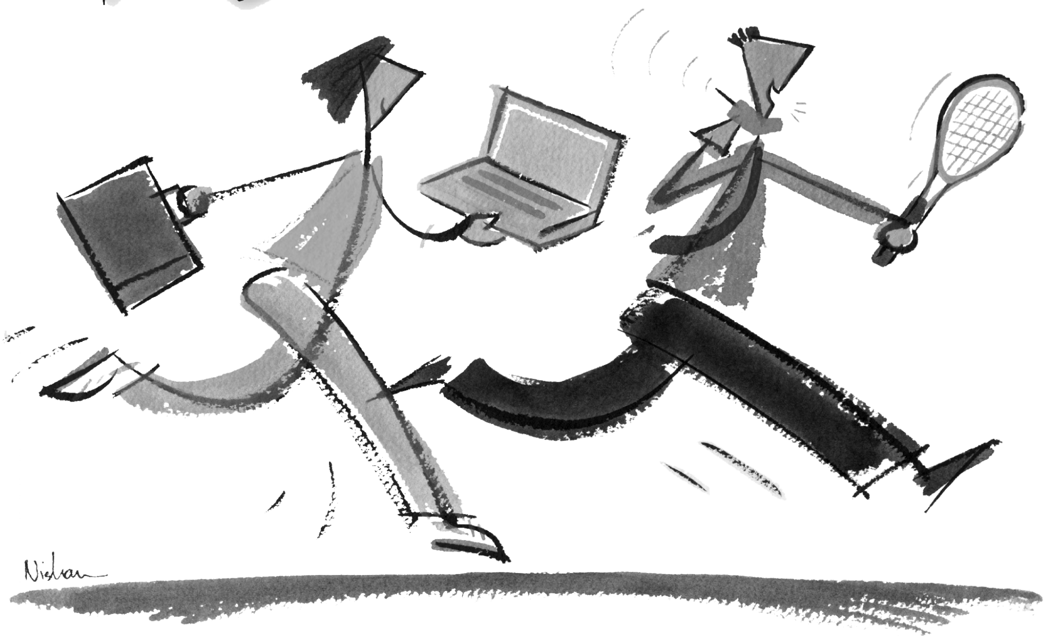

A Revolutionary Guide to Investment for a Revolutionary Generation

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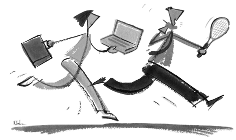

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To my love and inspiration,
the person whom I admire the most, my wife Lynn Astre.
Also in loving memory of my grandparents, the Astres and
the Guyons, and my beloved uncle Jeannot Guyon.
May you rest peacefully, I loved you all so much.

I also dedicate this book to my parents Jacques and Yvette Astre;
my in-laws the Astrauskas; my brother Jacques and his family;
my terrific children Paul Astre and Michelle Heil;
my son-in-law Christopher Heil;
my two wonderful granddaughters, Jillian and Janine Heil;
and their cousin Charlotte Astre.
You inspire me every day.

Preface

Revolution is sudden, complete and radical change. Although the retirement revolution may not have started recently, it sure has suddenly sneaked up on us. The change in retirement is both radical and complete because of the convergence of two momentous movements: ever-increasing longevity and the aging baby-boomer wave. The demographics are inescapable. A huge number of people 50-plus in age, with life spans pushing the century mark, combined with a deficit-riddled government unable to provide relief, may result in misery for many people.

I've been doing financial planning since 1969, and I've learned a lot in that time. I'm not just talking about technical knowledge regarding investments, taxation, and financial planning; that kind of knowledge is pretty straightforward and relatively easy to get through traditional studies and continuing education. The kind of knowledge I'm referring to comes from watching and working with people for a lifetime. That knowledge helped me understand the perplexing question of why, if financial independence

is so desirable, do only a handful out of thousands of people actually achieve it? The answer is simple: they lack one of the three essential elements—desire, belief, and know-how.

For a number of psychological reasons, some people subconsciously reject financial freedom. They fear the changes money might bring them, or they feel unworthy. Perhaps they saw their parents endure financial struggles for a lifetime and feel they don't deserve such "good luck." Whatever the reason, they will remain dependent on the nine-to-five grind, rarely move ahead, and enjoy very limited resources in retirement.

The second essential element is belief. I feel strongly that this is the primary reason why so many people never obtain financial freedom. They simply don't believe it's possible for them and just give up trying. As Anthony Robbins put it in one of his tapes, "If you believe you can do it, you can. If you believe you can't, you can't. Either way, you will always be right."

The third element, know-how, brings wonderful news for everyone. I have spent my entire working life studying and developing the strategies needed to achieve financial independence. I have achieved it myself and guided many friends and clients to this same result. When my wife and I married in 1964, we had a net worth under $100. As I write this book, we enjoy an above average lifestyle, and neither one of us has to do a stitch of work or anything else that we don't want to do. We never won Lotto, inherited anything, or received any windfalls. All we did was apply the commonsense strategies presented in this book you are holding in your hands right now. That's all the know-how you will ever need to reach financial freedom. Nothing is held back. There are no magic secrets for the privileged few or hidden windfalls for the chosen.

All you need to do is follow the very specific advice in this book, and you will reach a point where it is no longer necessary for you to kowtow to a boss in order to receive the weekly money needed to live. That's financial independence. Follow the guidance in this book and the continuing advice on my interactive web site, there for the taking by everyone, and that means you. I don't care what your background is, what your ethnicity or religious beliefs are, or what your IQ is; they don't matter. Unless you're serving a life sentence in prison, this book will work for you. The strategies are simple and easy to understand and can be implemented by all. Simple, commonsense clear solutions always work best. That's what you will find in this book.

I wrote this book for a number of reasons. After reaching a point in my life where I no longer had to struggle for the material things needed to live well, I found an inner peace, a tranquility of spirit, and I realized that a large part of this serenity came from the disappearance of money-related stress. I envisioned a world where everyone had this kind of mental peace, and I feel it is my calling to bring this to all, to let the world know it's right there for the taking with just a few simple steps.

There's another somewhat selfish reason for my writing this book. You see, when a person reaches financial independence, it doesn't take away from anything, it adds. Our economy and our society operates more efficiently, when it is filled with financially able people. The whole system, including government, functions with greater efficiency when it is filled with a population able to financially sustain itself well. I want my granddaughters to grow up in such a world. I want their futures to be bright. By contributing to the financial well-being of many individuals, the future will indeed be better for all of us, our children, and our grandchildren.

HOW TO USE THIS BOOK

This book will build a financial plan, step by step, chapter by chapter. Each section builds on the previous one, like bricks in a foundation. At the end of each chapter is a Progressive Plan of Action. This will tell you what you should have accomplished by the end of the chapter. When you reach the end of Chapter 15, you will have a fully executed financial plan that will earn you freedom from money worries and provide prosperity in the Age of Longevity.

An effective financial plan is a flexible organism. Tax laws change, the economy changes, and you will change. You must monitor your plan and be prepared to adapt it. That's what will bring you financial freedom. The Worksheet Section in Part III has a number of exercises to be completed at least annually or whenever your situation changes. It will keep your plan up to date as you move through your seasons of money. In addition, you will have access to my web site www.prosperousboomer.com, keeping you updated on the latest tax changes and other financial issues and strategies.

Prosperity Points are unique financial and audit-tested tax strategies. They will keep you on the cutting edge of tax and economic changes, always making sure you have the advantage no matter what scatterbrained legislation our politicians come up with. This section will be updated through yearbooks and www.prosperousboomeer.com.

So roll up your sleeves, and let's get going fellow boomers. The exciting world of the retirement revolutionary awaits as you start on the journey toward a nonlinear life, a journey of financial freedom in the Age of Longevity.

So I urge you to begin on this wonderful path toward financial freedom. It's simple and effective, and I will be there with you every step of the way with this book and my interactive web site to keep you up to date on the latest developments. So come on, let's get started. Longevity and prosperity await you.

PART I

Getting Ready to Retire

"Retirement is twice the husband, half the income." —Phyllis Diller

CHAPTER 1

Retirement Revolution

From Misery to Paradise in 1,000 Years

He hacked at the hardscrabble ground with rudimentary wooden tools hewn from living trees, wrested from the earth at the price of his sweat, his blood, the essence of his life that was being worn away by each back-breaking day of mindless toil. Pain flared in his right arm, a constant reminder of the accident—a compound arm fracture—that had almost killed him as a child, an accident very few people of his day survived. Shadows from the giant oaks surrounding the field stretched across the road like dark spirits as the sun disappeared. The last clouds gleamed a reddish gold, contrasting with the green tops of the trees.

He gathered the few precious roots and wild mushrooms, balanced them on the small hand-drawn cart with its crude wheels, and began

the trudge home where his wife awaited with their last two surviving children. Home was a coarse wood structure, padded with straw and mud, barely able to keep out the worst weather. Three children had died from the coughing disease and the consumption that passed through the countryside last winter. His steps were slow and measured. By the standards of his day, he was an old man, a survivor perhaps, but well past his prime and living on borrowed time. He couldn't know that on that very evening, he was living out the last of his days. Plague would sweep through the village later that year, killing him and his family.

It was 1011 A.D. and he was 30 years old.

• • • • •

We have always been a short-lived people. Our friend was well above average for his day. He survived a fracture that would have killed most of his contemporaries from infection and lack of medical care, although for a modern American, it might require merely a night or two in the hospital. For his time and his age, he had beaten the odds. The average lifespan then was 25 years.

Life in 1011 A.D. was brutish, rough, and miserable. It was also short for most people. No wonder the populace sought comfort and solace in religion with beliefs of a better hereafter. They lived in misery all of their brief lives. It would take a thousand years for some sectors of humanity to go from misery to paradise. But clearly, here in the United States, we have arrived at a point as close to paradise as we can find on earth.

As the Dark Ages gave way to the Renaissance, longevity slowly increased. However, progress was monumentally slow. It took 800 years for life spans to reach 38 years. Only the last century saw dramatic progress in life spans.

If you look at Figure 1.1, you will see that on the first day of the 20th century, the average life span was 47 years. On January 1st of the new millennium, a person could expect to live 76½ years. There was a greater increase in life expectancy in the last 100 years than the previous 1,000 years. Perhaps this quote from one of Dr. Ken Dychtwald's speeches sums it up best:

> *We are in the moment of movement towards a long life where throughout all of history, we have been a short lived people. The question is, how far are we going to go? What we have to appreciate is that the biological potential of the human body is believed to be somewhere between 120 and 140 years. So the fact that we're living 75 or 80 years is pretty terrific, but we really haven't even begun to scratch the surface with regards to longevity. The new tools of medicine, biotechnology, stem cell technology, nutraceuticals, cosmeceuticals are about to usher in a new era where many of you and many of the people with*

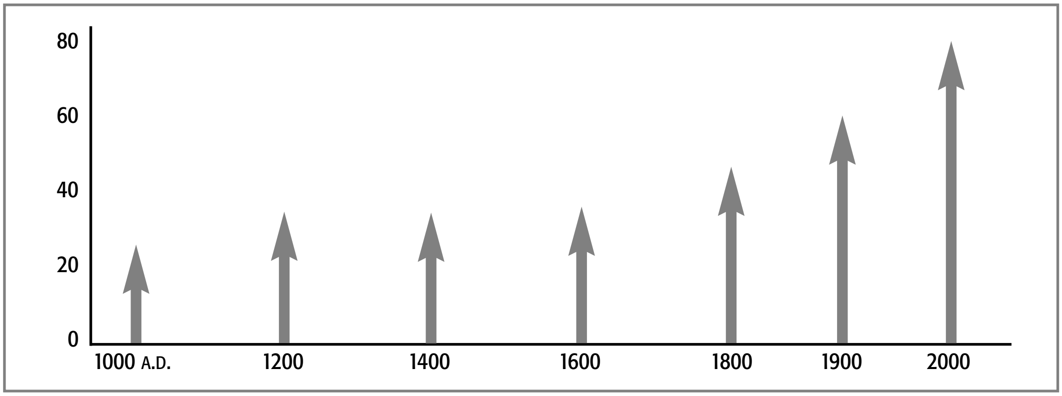


FIGURE 1.1 Average Life Expectancy at Birth from Year 1000 to Year 2000 *(Source: U.S. Census Bureau)*

whom you relate are going to live not 80 or 90 years, but 100 years, 120 years and maybe more.

Dr. Dychtwald goes on to suggest that in coming years, longevity will be purchasable. People will be able to buy another 20 or 30 years of life if they can afford it. That day is already upon us, has been for a while, and it's going to get worse. No one argues that poor people, lacking health insurance, receive the same priorities and procedures as people with good insurance and funds for co-payments and deductibles and amenities. Although patients are not left to die in emergency rooms because they have no money, the fact remains that those who have reached financial independence live longer than the poor.

Physical health is only half the story. State of mind is equally important. Financial problems are a leading cause of stress, worry, and fear and can bring about physical collapse.

We live in exciting times. Baby boomers born between 1945 and 1964 are riding the wave of the greatest societal change since the industrial revolution: the longevity revolution. But this revolution requires a special way of thinking, new ways of looking at life and money. This book will take you down that path, the road to financial independence and success in the Age of Longevity.

We were revolutionaries once. Sometime during the 1960s we manned the barricades, wore tied-dyed shirts, grew our hair, waved our peace signs, shouted "down with the establishment," tried to turn society upside down, and almost succeeded. Our numbers shook America as we grew up, over 74 million strong. Then a funny thing happened. The person who coined the slogan "never trust anyone over 30" turned 30. We moved away from our assaults on midstream America and *became* midstream America.

And now fellow boomers, I suggest to you it's time to become revolutionaries again. Not the angry, marching, down-with-the-establishment extremists we were in the '60s, but new kind of radicals: retirement revolutionaries. Let's think differently. Let's take action, grab the opportunity, and enjoy the paradise laid out before us by taking control and becoming financially independent.

This is not traditional paradise where we walk through pearly gates and there it is, all laid out for us. Oh, it's there for certain, but we have to do the things necessary to get it. Fortunately, those things are within reach for everyone with the ability to take this book home and follow the simple steps in these pages. Armed with this book, you will surely realize the old Star Trek maxim: Live long and prosper.

SEASONS OF MONEY

We are fascinated by seasons. Their ebb and flow pulse into our lives and influence our literature, our music, and our moods. Seasons are markers, inexorably setting out the passage of time.

In New England, each season has its own distinctive flavor. Spring comes with riotous explosions of colors in flowers and awakening vegetation. The sun drives out the chill of winter imbedded in the soil. There is renewal, growth, and promises of the long summer ahead.

As we go through seasons, one thing is so clear we don't even think about it. That one thing is the surest fact we have, the one unbreakable guarantee to us all: time passes.

Time passes no matter what. Through good days and bad, famine and abundance, deadly sickness and roaring good health, time passes. The seasons pass. Sometimes it seems that nature grasps at remnants of a season, attempting to hold the heat of September through an October Indian summer.

But no matter how much we would like to prolong our favorite season, it's just not possible. We apply this same outlook to our lives. We compare moments to the earth's seasons. Poets and songwriters croon about the "spring of our lives," the "autumn of our days," "June-September marriages," and so on. The overriding fact is that we have no control over the inexorable march of time and the seasons of our lives. Change happens whether we like it or not.

Parallel to our lives, our finances also go through seasons. In my first book, *Four Seasons of Money* (Palisades Publishing, 2000), I outlined the stages, the seasons, of our money.

The first season, *spring,* is the time when we begin to feel the need for security through money. We start to build up savings and assets. These are the accumulation years and for the average person they are the longest years.

During the season of *summer*, you're almost there. Perhaps just a few more years will do it. Now is the time to prepare for financial independence or retirement. Debt must be eliminated or reduced to a manageable state. There can be no financial independence with debt. Excessive debt is like floodwaters on a fire; it will drown and extinguish a financial plan. Other issues must be addressed, such as cash flow, life insurance, where to live, and whether to pursue second careers. This is called preretirement and life planning.

Fall is the time where we have reached financial independence. There is no longer a need to work. Assets are providing cash flow, and we have freedom of choices. Sure, we can work, but it's an elective. It's something we choose because we want to and not because bills must be paid. In the financial autumn, expenses are paid from cash flow out of our independently owned, income producing assets.

The final season, *winter*, is not a financial season like the previous three, but it is equally important. It is a stage of life. Winter is the time we must make arrangements for handling our care as our bodies weaken. It is the time where we must prepare for passing the wealth we have created and enjoyed to future generations. This is called estate planning.

Throughout this book I will guide you in each specific step you must take to achieve success in all four *seasons of money*. I will tell you exactly what must be done, the best way to do it, and how to avoid the obstacles. When we reach certain issues that are beyond the scope of this book, I will guide you toward reference materials. But right now here is the most important issue for *your* four seasons of money:

> *There is no natural time element to a season of money. Unlike the seasons of the earth, there is no set progression to the passing of these stages. You can be stuck in one season and never move out of it unless you make it happen.*

The year was 1956; the place was Malta Street in the New Lot section of Brooklyn, New York. I was 12 years old, and all was right with the world. Ike was President, the Dodgers were in Brooklyn, the Subway Series between the Yankees and the Dodgers was in full swing, and the summer was like caramel, sweet, delicious, and hot.

At the end of the steaming day, adults would get folding chairs and sit on the cooling sidewalks with the other families of the neighborhood. As darkness fell, I remember the greatest sound a 12-year-old could hear at that time: the tinkling jingle of the bells on the ice cream truck. Clutching pennies, nickels, and dimes, kids would surround the truck, a boxy white affair festooned with color photos of the treats within its dry-ice fogged interior. The tumult slowly died out as each kid received the treat and withdrew to the concrete stoops of the brownstones.

My favorite was the Italian ice, cherry flavor. I would peel off the cardboard cover from the frozen mass and attack the sweetness inside with a flat wooden spoon. Ah, the things you could get with a nickel in 1956.

I would scrape the hard frozen surface until I had a small slush ice pile that would release its cooling flavors on my tongue. As I made my way through the ice, it began to get softer and easier to scrape until I would be able to get gobs of it down at once. After the first three quarters, the real treat began. The bottom was softer and redder where the cherry flavor had been concentrated, and it was squishier and easier to get. It was the best part of it all.

As I thought about those childhood days in Brooklyn, it occurred to me that those Italian ices are a grand metaphor for the financial seasons. You start out struggling and scraping, and it seems so hard. As time passes and your financial life builds, it gets a little easier, a little softer. Finally, as you approach financial independence, it just gets sweeter, easier, and tastier.

With the strategies and worksheets in this book, you will be able to determine which season you are in, and you will have exact road maps and strategies to reach that sweetest of all seasons, financial independence and a rewarding longevity. Truly, you will have reached paradise.

SAM AND JOANN: PIONEERS OF THE NEW LONGEVITY

I met Sam and Joanny about 20 years ago. It was the early 1980s, disco was still thriving, and their second child had just left the nest after graduating from Hofstra University in Long Island, New York. Sam was tired of his work. He wasn't physically tired. He was only in his mid-50s. His plumbing business was doing well, and they had a good hold on their money through an active financial plan.

Sam had a tiredness of spirit. He felt the pull of something tugging at him. He felt time was passing him by, never to return, as he grew older. His favorite saying was "you only go around once." Yes, you do, Sam. We all "only go around once." Sam wasn't the only restless one. They had raised three kids, and Joanny had only been able to work part time at a series of unfulfilling jobs. She had always been interested in real estate, but because of the demands of child rearing, had never been able to give it a serious try.

And so we began planning for Sam and Joanny, planning a life that would break the traditions of the past, for a life of fulfillment and, as it turned out, longevity. Sam and Joanny are still going strong as they approach their 80s. They were my first clients for whom I saw the possibilities of nonlinear, nontraditional life planning and the part I would play in it as financial advisor. I couldn't articulate it back then as I can now, but I knew that we had to begin thinking differently, both as advisor and clients.

Sam loved history. He wanted to do something that would help uncover our historical past. We each began to play our respective parts: Sam and Joanny's to find exact ways to ensure their need to move onward productively in their lives and mine to make certain financial considerations would be handled. My goal was to be sure the financial plan would facilitate their life plans.

Fortunately, we had an effective ongoing plan. We had used a number of strategies that had built effective wealth over the previous decade. We had tax methods in place that funneled money into the couple's investment plans instead of government coffers. We had set up contingency plans for business and wealth transfers and tax-free exchanges of primary homes. (At that time, tax rules for sales of primary homes were quite onerous. They have been relaxed considerably since and present many opportunities that we will use in this book.) We put all those strategies in action and did a 90-degree turn with their financial plan. Over the next three years, Sam and Joanny realized their dreams.

Sam went to work part time for the National Park Service. He gives tours of historic sites in St. Augustine, Florida, the oldest city in America, a veritable treasure trove of history. When he's not giving tours, Sam spends weeks and sometimes months on historical digs and projects throughout the United States. Joanny became a licensed real estate agent and went on to open her own business specializing in the seasonal Florida homes.

As of this writing, Sam is more involved with historical research but still enjoys occasional stints as tour guide. Joanny sold her business a few years ago and devotes much of her time to charitable causes. They travel frequently visiting children and grandchildren in New York, California, and Tennessee. They have discovered the paradise of a new nonlinear life, longevity, and financial independence. The real message here is that you, reading this book right now, can do this. Neither Sam nor Joanny went to college. Sam has a GED high school education. They are not geniuses, never inherited anything or won Lotto; they are average people who followed sound, specific, financial planning advice, the same advice you will gain from reading this book.

THE FREEDOM OF NONLINEAR LIFE PLANNING

Throughout history, most people were locked into a linear life until they died. They were born in a certain region, country, or city; grew up there; and worked at tasks picked from narrow choices. They married, raised families, and continued in those occupations until they died. It was all straightforward, linear.

Before the 1900s, most Americans worked at farming and ranching. Others, in much smaller numbers, were engaged in various professions, such as blacksmiths, carriage makers, printers, lawyers, and doctors. The common denominator was the linear life. Seldom did a blacksmith become a lawyer, or a rancher become a doctor. They pretty much stayed on a straight line throughout their lives.

Then the industrial revolution came along, bringing new life for workers. Industrialization beckoned millions from farms and rural areas to teeming cities and their factories. Whether life was better for them than it had been on the farm is an endless debate. One thing remains for sure: life continued to be linear. It was a straight run from working, raising a family, growing old and dying.

As the 1950s, '60s, and '70s rolled around, a new phenomenon appeared, a new idea: the concept that you could actually stop working and relax, enjoy life, and pursue leisure pastimes of your own choosing. However, it continued to be linear. By the '70s, it had shaped up as follows:

- *Childhood and education*. This could be from 14 to 22 years, depending how far your education went. Even during that period, lines were straightforward and defined. Boys took shop in high school, and girls went to home economics.
- *Marriage*. You fell in love and got married. It was going to last forever, and it did—for 50 percent of us at least.
- *Career*. Workers in the 1950s and 1960s were not very mobile. Most stayed in one line of work, one field, usually not even changing companies more then once or twice.
- *Children*. Yes, we raised 2.4 children.
- *Preretirement*. A pattern formed. We went on a cruise a year before retirement. We returned to a "surprise" retirement party and a gold watch. We sold the house and moved to Florida because as Seinfeld once said, "That's the law!" We learned shuffleboard and fly-fishing. Reaching age 65 sure had its benefits. We never got bored, never had time. Because five years later, we were dead. The average retirement age was 65, and average lifespan was 70.

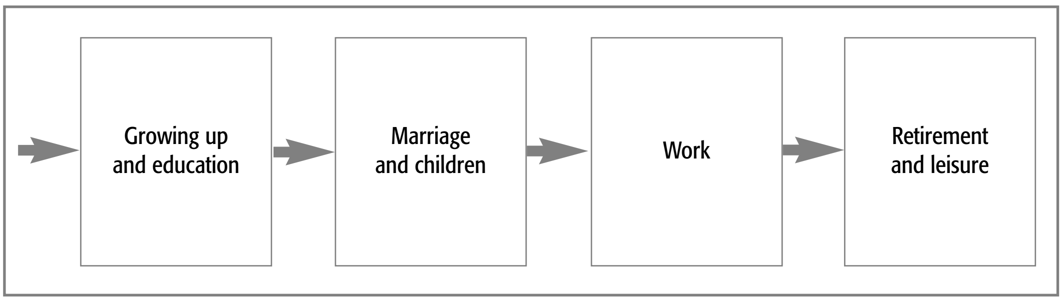


FIGURE 1.2 The Linear Life

Not everyone had marriage and children. Some skipped it, whereas others had it several times over, but for the average person that's pretty much the way it went.

We were locked into the linear life, see Figure 1.2 bound on straight tracks with no deviation. So what's wrong with that? Why can't we keep this paradigm in the Age of Longevity? The answer is both simple and complex. You have to address two questions if you're going to retire and live 10, 20, 30 or more years:

1. You can't play shuffleboard for 30 years. What are you going to do with yourself?
2. How are you going to pay for your retirement?

This book will answer the second question by giving you the means to achieve financial independence. Once you have this, the question of what to do with yourself gets easier. You see, the old question was:

What can I do with myself within the confines of having to work for the money?

Once you follow the guidelines in this book and become financially independent, the question changes entirely, and the answers are numerous and empowering:

What can I do with myself now that earning a living is no longer a concern?

You will find the answers lie in breaking the old thinking patterns, the stale ideas rooted in a world where lives were short. Adopt new ideas, revolutionary concepts; adopt a nonlinear life. See Figure 1.3.

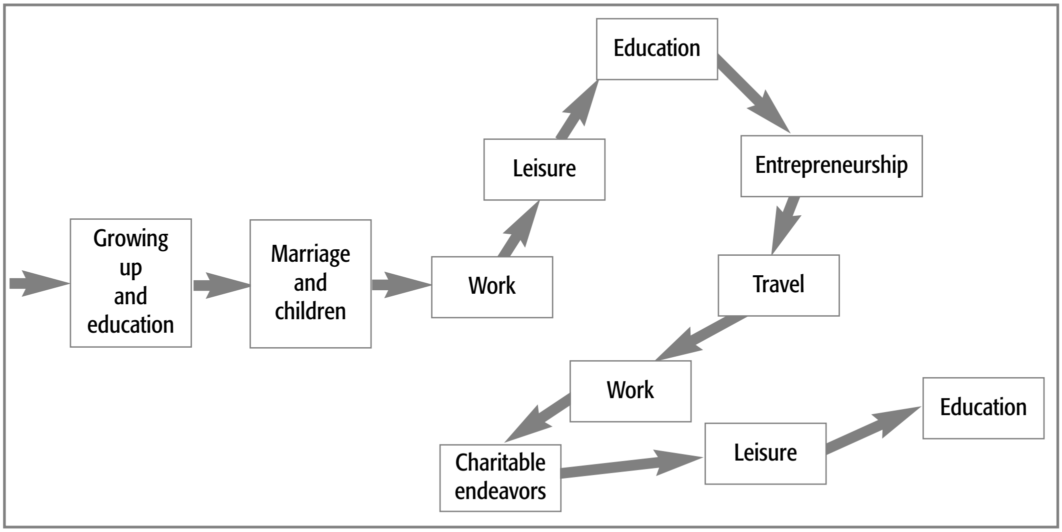


FIGURE 1.3 The Nonlinear Life

The possibilities are endless in the nonlinear life. This is life the way it should be lived. We weren't meant to spend our entire lives scrambling for money just to pay bills each month. If that's the way it turns out, it's because no one ever taught us, ever showed us the possibilities. In our society, right now, by following the strategies outlined in this book, the nonlinear life awaits every person in every generation, not just the boomer generation.

THREE STEPS TO FINANCIAL FREEDOM

It's not just about financial freedom. It's about total freedom, the power to be who we want to be and accomplish what our hearts yearn for. The start of it all is financial freedom, and here discipline works particularly well. It consists of using three basic principles of human behavior. If you follow these principles, embrace them, and make them your own, I *guarantee* you will succeed and achieve financial independence.

Principle 1: Perception Is Reality

I could take dozens of the smartest, most knowledgeable financial advisors and meet with you to offer the best possible financial advice available. This would be 24-karat, solid gold advice. None better in the world. But if you took no action, the advice would be worthless. If it was your belief, your perception, that it was impossible for you to improve your situation, then it would be impossible, not because of reality, but because of your belief. Whatever your belief is will become your reality.

Perception is something you create in your mind. It is thrust upon us by society, by teachers and parents, by well-meaning people, and by some not-so-well-meaning people. Whatever perception we accept, change, or create becomes our reality because our brains will cause us to act upon that perception. Perception becomes our reality. It either restricts and limits us, or it empowers us. From this moment on, I want you to begin thinking in a special manner. I want you to create a perception of success.

I can achieve financial independence and a life of constant joy and discoveries. I will do this because I believe I can do it, and my beliefs empower this reality.

Principle 2: Take Responsibility

The trend of our society is toward a blameless environment where no one is responsible for anything. It is always someone else's fault, someone else's responsibility. A good portion of this comes from the legal system and its average

35 percent contingency fee for tort lawsuits. (A tort is a lawsuit where someone has caused injury, grief, pain, or damage.) To be sure, there are many cases where someone else should be responsible, but in recent years torts have reached absurd levels. No matter how dumb a person's behavior is it is never his or her responsibility.

A woman buys coffee at a McDonalds in California, spills it, and burns herself. She sues and wins a million-dollar judgment. A court ruled that the restaurant did not warn her that the coffee was hot and could result in burns if spilled. This suit is the reason you see idiotic three-paragraph signs in McDonalds telling you coffee is hot.

Stupid warnings abound, symbols that people are not responsible for even the scantest shred of common sense. Here are a few to chuckle over:

- On a package of whole walnuts: "Remove from shell before eating."
- On a hairdryer: "Do not use while showering." (How would your hair dry anyway?)
- On a can of caustic radiator cleaner: "Do not drink."
- On a can of wheel bearing grease: "Do not eat."

So where is this leading? We are creating a society where there is no responsibility. Only business and government has responsibility. Individuals should not be responsible for anything. That is completely false. The government will never make you financially independent, neither will your employer. Only you have the power to grasp money success, if only you believe and take responsibility.

Take responsibility for your financial future. Respond with ability, the ability to make positive changes by following the recommendations described in this book.

Principle 3: Accept No Blame

At first glance it would seem that not accepting blame clashes with accepting responsibility. That's not true. Blame is a destructive emotion whether you blame yourself or someone else. It is a mental tear-down, a psychological wrecking ball. Two of the most destructive phrases in the English language are "I failed" and "You failed." Blame and failure paralyze and create fear that holds us back, stopping us from trying again.

I want you to take a hold of this idea. It's a concept that will bring positive changes throughout your life and especially in your finances. There is no such thing as failure.

You *cannot* fail. You were made in the image of your creator, and failure was never part of the plan. You cannot fail. Failure does not exist, and the word should be removed from our language.

What's that you say? I'm wrong. Your child came home from school with a report card that says "F," failed. You took a state civil service exam, and the state sent you a letter that says you failed.

Obviously there is such a thing as failure, right? Wrong! You cannot fail. You did not fail. You simply got different results then anticipated.

Different results. That's positive, not negative. It's constructive, not destructive. You can always go back and figure out how to get the results you want. History is filled with examples. Did Thomas Edison fail to invent the light bulb? Did Alexander Graham Bell fail to invent the telephone? Of course not. However, they often got different results than anticipated, sometimes hundreds of them, before they got the results they wanted.

Sure it's in our heads. Of course it's a perception. That's okay. Remember, perception is something we create in our minds, and it then becomes our reality.

You cannot fail. It's important to develop that mind-set. Setting out on the road to financial independence will surely bring setbacks. The anticipated raise or promotion might not materialize. Maybe there will be layoffs. Who knows? Don't let anything hold you back. It's not failure, just different results than anticipated. Go back and try again, and you will get the results you want. It's only a matter of time. You will have success because you cannot fail.

> *You cannot fail. You may encounter times where you will get different results then anticipated, but you cannot fail. Ultimately you will get the results you want.*

So let's get going. Let's take action and begin the journey. The steps are in this book and they are easy for anyone to understand. You can achieve financial independence and begin the life you only dreamed about. It's there for all to achieve.

SOCIAL SECURITY UPDATE

In the opening remarks of his press conference on April 29, 2005, President Bush stated: "Social security worked fine during the last century but the math has changed. A generation of baby boomers is getting ready to retire." Factor in the average return of social security funds, a paltry 1.6 percent, and as the President went on to quote, "the system is headed toward bankruptcy."

The opposition to President Bush's private account plan for social security falls into three general groups:

1. Those who recognize the problem and identify problems in the President's proposal, but have no alternate plan of their own.
2. This group also recognizes the problem, but maintain it won't happen until 2041, and do not want to do anything about it now.

3. The third group says "What problem? Everything is fine, just leave things as they are."

Now I know 35 years is a long time, but you don't make changes or see results instantly. Time is needed to avoid the crisis. Social security changes are like steering the Titanic. You don't yank the wheel at the last moment to avoid the iceberg. You need plenty of turning room.

Private accounts will work, but there are three problems in the President's plan as it now stands:

1. *Funding.* If one-third of social security payroll taxes goes into private accounts, the system will be unable to continue funding retiree benefits at present levels. This is correct and can be fixed with a modest tax increase. A 0.5 percent income tax or 0.25 percent payroll tax put into a trust fund is reasonable and will solve the funding issue. TANSTAAFL comes to mind from that great author Robert Heinlein in his classic novel *The Moon Is a Harsh Mistress*. It stands for There Ain't No Such Thing As a Free Lunch.
2. *Investments.* The stock market has risks, but when done correctly, risk can be eliminated, and the plan does not spell that out. An unmanaged basket of index funds with a 30 year timeline is the answer. Since the beginning of recording such things there has never been a 20- or 30-year period in which large indexes have lost money or failed to beat inflation.
3. *Investors/Brokers/Advisors.* Social security is too important to allow errors and the emotional mistakes that occur when individuals manage investments. Contributions should go into a predetermined basket of indexes, and left alone to do their job without tampering.

If a viable plan to fix social security is not created, we will see a ratcheting up of the "misery index" with retirement at higher ages and lowered benefits. It may be 35 years before we see the result of doing nothing about social security. I know that 35 years is a long time, and many of us, myself included, may be dead by then. But is that the kind of legacy we want to leave for our children and grandchildren?

Now here's my advice for everyone to create their own social security. Go back to page one of this book, read it, take action, follow the recommendations, and achieve financial independence on your own. That's the only real security you will have.

JONATHAN'S STORY: GOD AND MONEY

I first met Jonathan when he asked me to file an amended tax return for his corporation. His accountant had made an error in his favor and would not amend the return. Jonathan is a deeply religious man. For him, honesty has no bounds. I admire Jonathan and try to emulate him as best I can. I amended his tax return, and he paid the additional tax. Over the next few months, as his financial advisor, I had the privilege of getting to know him.

Jonathan's goal in life was to follow the scriptures and help the needy and hungry. He tithed to his church and gave large amounts to various charities. Still, he was not satisfied with just that. His painting business employed a dozen people, and he was doing well. What he really wanted to do was devote his life full time to helping the needy. My analysis showed that he could be self-sustaining in six years if he stopped contributing to charities for a while and concentrated on achieving financial independence.

Jonathan didn't like the idea, but my logic was compelling. We agreed on six years. He worked hard and had a couple of good years, and we reached our goal in five years. Jonathan now had several streams of income available and no longer needed to work. He sold the business in the beginning of the sixth year and applied all the proceeds to opening an organization to feed and help the needy. I filed for 501(c) recognition and the IRS approved the charitable status. Jonathan was realizing his purpose, what he believed God had called upon him to do.

Jonathan's organization, Harvest Times, operates from Florida to North Carolina. It gets large stores to donate excess food and merchandise. It is picked up, shipped to warehouses where it is sorted, and then trucked to churches and community organizations that distribute it to needy people. Jonathan runs this full time. He doesn't take a penny from the organization; everything is plowed back toward helping the needy. Jonathan now does more good in one year then the combined total of all his contributions and tithing before he reached financial independence.

That's what this book can do for you. It can bring freedom to do what your life's work is meant to be. You don't even have to know what that is right now. Your dream will find you when you have broken the shackles and achieved financial independence.

When the pupil is ready to learn, the teacher will appear.

"Love conquers all things, except poverty and toothaches." —Mae West

CHAPTER 2

New Ideas, New Paradigms

I grew up in Brooklyn, New York. The neighborhood was 95 percent Jewish. We were the only Catholic family on the block, and this put me out of sync with my friends. On Saturdays, when my day was free, they were off to Temple or Hebrew school, and on Sundays, when they were free, I had church and Catechism.

It was on one of those lonely Saturday afternoons in 1955 that I had an idea. I rode my bike up Pennsylvania Avenue toward Canarsie to a pond off the Avenue. Back in those days, they still had some ponds in Brooklyn. I carried a big jar in the basket of the bike—a red Schwinn by the way—and when I reached the pond, I filled the jar with water and dozens of tadpoles. You all know what tadpoles are: little frog wannabes.

I rode back home with my tadpoles. My idea was to start a pond in the lot back of our house and populate it with tadpoles that would eventually become genuine Brooklyn frogs. As I rode, I had another idea. An idea that at the time, I thought was really great. I put my jar of pond water and tadpoles in a corner of the garage. Then I got up at 2 or 3 A.M. I sneaked out, got my bike and tadpoles, and rode to the church. I ran into the church with my tadpoles (churches were open all night in 1955) and dumped them in the holy water.

The next morning, Sunday morning, I couldn't wait to get to church. As we approached the entrance, there seemed to be a holdup. As the parishioners went in, they would dip their fingers in the holy water and do a little jump-back when they saw what was populating the holy water.

There, under the watching eyes of the Virgin Mary, all those little tadpoles were swimming around. It was sort of like a combination of Dante's Inferno and Waterworld. But still, I was uneasy. I began to wonder how good an idea that had been. After all, look who I was playing a joke on. This could turn out to be serious. So I decided I better play it safe and get the slate wiped clean. You see, that's what's great about being Catholic. You go out and sin, go to confession where everything is forgiven and then you're ready to party again! Now you might wonder, what a 10-year-old boy could have to confess. Well, even at 10, you begin to have goals. One of my goals was not spending all Saturday afternoon doing penance. If you confess too much, that's what will happen. If not enough, it will be the same thing because they'll think you're leaving stuff out. So you give them the Big Three: lying, stealing, and impure thoughts. You get ten Our Fathers, ten Hail Marys, ten Acts of Contrition, and you're out of there in 15 minutes, tops!

So the following Saturday, my confession went something like this:

> "Bless me father for I have sinned, I lied, I stole, I had impure thoughts, and . . . I put tadpoles in the holy water."
>
> "What was that my son?" replied the priest, "I did not hear that last one."
>
> "I . . . uh . . . put tadpoles in the holy water."
>
> "What! You're the one! I had to take every one of those little slimy creatures of God out by hand! You can't just dump out holy water you know!"

I got 50 rosaries, a penance worthy of Charles Manson, and I had to clean out the rectory every Saturday for the rest of the summer. So you see, in retrospect, that wasn't a good idea. One of the secrets of life is being able to know the difference between good ideas and bad ideas. Ideas are everything we have, ideas are all that we have, ideas turn into the greatest of creations and the worst evils, and everything in-between. Some ideas will be profoundly life changing; others will flounder aimlessly, doomed like those tadpoles in holy water.

IDEAS TO PARADIGMS

But ideas don't just stop there. Ideas can grow into paradigms. Paradigms are an amalgamation of ideas into a set of beliefs, of practices that we follow. Sometimes that's very good. But remember, the constant of the universe is change. We must be ready to act on new ideas, new circumstances. So at times, when paradigms should retreat and change before new ideas, we find they often hold us back.

In the early 1960s, over 80 percent of watches were made in Switzerland. Then along came people with new ideas, new circumstances, and technologies. They wanted the Swiss to start making watches that would work with quartz movements powered by tiny batteries and eventually by microchips that would flash digital numbers.

The Swiss said, "No! Don't tell us how to make watches. That kind of thing will never work. We know how to make watches. We've been making timepieces for centuries. Watches have cogs and gears and springs that you wind up. That's how watches are made!"

That was their paradigm, based on centuries old ideas, and they refused to change it. Less than 15 years later, as the '70s drew to a close, over 80 percent of watches were manufactured outside of Switzerland.

This book brings you new ideas and a new paradigm, one that will deeply affect each and every one of you, a paradigm that is like the elephant in the living room: it cannot be ignored.

We stand at the convergence of two powerful forces, never before seen in human history. The first of these forces is the longevity revolution. We've seen the facts in Chapter 1, we see it every day all around us, affecting everyone, but especially the lives of those who want to retire.

The second powerful force converging right here and now is the baby boomers. Born between 1945 and the mid-1950s, 84 million strong, they have reshaped our society.

As Dr. Ken Dychtwald explained in his best-selling book, *The Age Wave* (Bantam, 1990), the boomer generation has become a huge demographic wave, moving through American society like a pig swallowed by a python. This baby boom turned age wave careened through the second half of the 20th century like a great ocean tidal wave, affecting everything it passed with its awesome demographics, changing and reshaping our society. Initially, there weren't enough hospitals for the great number of boomer births, not enough schools to educate them, nor enough homes for the new families to live in, so the great construction booms of the ’50s and ’60s began, making names like Levitt and Levittown familiar to everyone.

Opportunities abounded for those who could read the demographics: In the late 1940s, it was said that American mothers would always make their own foods for their little babies, so why invest in foolish companies such as Gerber and Beech-Nut. They’re bound to fail. Yes, old ideas died like tadpoles in that holy water, and new paradigms enriched those who could recognize change.

In the early ’70s, the Estee Lauder model was a lovely young woman named Karen Graham. In 1973, she was fired when she turned 24. That was much too old for a beauty model. Recently, Estee Lauder hired a new model to represent their products, none other than Karen Graham, still lovely at age 55. The message here is that no matter what business you’re in, you had better understand the demographics of baby boomers, what they wear, what they put on their skin, what they drive, what they like to eat, and what they buy for their children and grandchildren. And you must especially understand it from a financial independence point of view.

Now baby boomers want to retire, and they and future generations are running up against an old paradigm that will not work in the age of longevity. They’re coming up against the linear life and traditional retirement ideas that are no longer valid.

IT’S NOT YOUR FATHER’S RETIREMENT

In the 1980s, General Motors’ Oldsmobile Division found itself in a bind. Studies showed that the younger generations were not buying its cars. It was the same aging generation that bought Oldsmobile, a generation that would soon be depleted by death. To bring younger buyers into its showrooms, Oldsmobile started an ad campaign called “Its Not Your Father’s Oldsmobile.”

Well, it’s not your father’s retirement either. Previous generations have followed a linear life with clearly defined and limited boundaries. You went through an education period, found a job, and got married—for forever, which was true for only 50 percent of us. Then you had 2.4 kids, pretty much stayed in the same job and occupation until you approached 65. You retired and died five years later.

Not much planning was required, financial or otherwise. But now, facing longevity, those ideas have turned into so many doomed tadpoles. Clearly, the old paradigms will no longer work. Someone retiring within the next 10 years will face 30 to 40 years of retirement.

In 2001, the average 65-year-old could expect to live for another 19 years (U.S. Dept. of Commerce, Bureau of Economic Analysis, 1998). Right now, the average time in retirement is 25 years. So each potential retiree *must* adopt a new paradigm, a paradigm that answers the following questions:

- What are you going to do with yourself for all those years?
- How are you going to pay for it?

You surely don't want your golden years to be what that great retirement expert Phyllis Diller described: "Half the Income, Twice the Husband!"

One Hundred Average Americans

In the 1980s, the Social Security Admistration and Department of Health, Education and Welfare released a set of startling statistics. Those figures and percentages were used by the Franklin Life Insurance Company of Springfield, Illinois, in a presentation for its agents called "The Story of 100 Average Americans." The drama of the presentation does not take away from the truth of the figures. (I have simply rounded off the figures to the nearest whole numbers.)

> *The Story of 100 Average Americans*
> Between the ages of 18 and 65, the average American will earn between $1 million and $2 million, depending on education, training, and part of the country where he or she lives and works.
>
> Yet, at age 65, out of those 100 Americans:
>
> - Only four will have income $35,000 per year or higher.
> - Over half, 51 out of 100, will have income averaging only $12,500 per year.
> - Out of 100, 25 will die.
> - About a quarter of them will not survive to 65.
> - Out of 100, 20 will have income at or below poverty limit averaging $6,000 or less per year!
>
> *Note*: Income is calculated from retirement sources only. The above figures do not include salaries of people who must continue to work beyond age 65. Some will literally work until they die. Statistics include all geographical parts of the United States.

Clearly these figures do not point toward a bright new future of prosperity in the Age of Longevity. New ideas are needed. So has a new paradigm taken hold now? Are we heading in the right direction? The baby boomers are approaching retirement age, but are they approaching financial independence? Let's take a look.

New Paradigms or More of the Same?

To become a true retirement revolutionary, to reach financial independence and adopt a nonlinear retirement that will give you fulfillment and prosperity, you must accomplish two basic steps:

1. Reduce debt so it is eliminated by the time you reach our targeted retirement age.
2. Save and accumulate the assets that will provide the cash flow needed for financial independence, without the need to work.

So how are Americans, especially baby boomers, doing on reaching these two crucial goals? Are we at least heading in the right direction? The signs are not encouraging. According to a recent survey, one-third of people born after 1979 (known as the millennial generation) entering the work force refuse to contribute to their 401(k) plans. (CIGNA Retirement & Investment Services, "Workplace Reports on Retirement Planning," October 2003.)

How about our boomer generation, approaching retirement age with devastating speed? Are they using new paradigms, paying attention to their finances? It doesn't seem like it. Consider the results of a recent study, *GE Financial 2003 Retirement Income Readiness Survey*, conducted by Opinion Research Corporation:

- 60 percent expect to spend at least 15 years in retirement.
- 68 percent believe they will need at least 75 percent of today's annual income during retirement.
- 41 percent are not familiar with the term "Retirement Income Planning."
- 45 percent could not correctly define an annuity.
- 51 percent said they plan to do both of the following during retirement: "Spend down" their retirement savings, and convert the savings to a regular monthly income stream. (Some obvious contradictions right there.)

Okay, so it's obvious not enough planning is being done among boomers. But how about savings, how are they doing in that area? Not very well it seems!

The above study also shows that those people hope to have saved under $500,000 by the time they retire. Yet another study in 2003 reveals that fewer than 25 percent of Americans age 40 to 59 have saved at least $100,000 toward retirement (The American Savings Education Council and Employee Benefits Research Institute).

But it gets worse. The personal savings rate has dropped steadily since the '80s and now has reached negative territory.

How about debt? Are we at least holding the line in that area? Figure 2.1 shows we are far from it. The debt level has climbed so high that it's beginning to seriously worry economists. The results of such unprecedented debt levels are

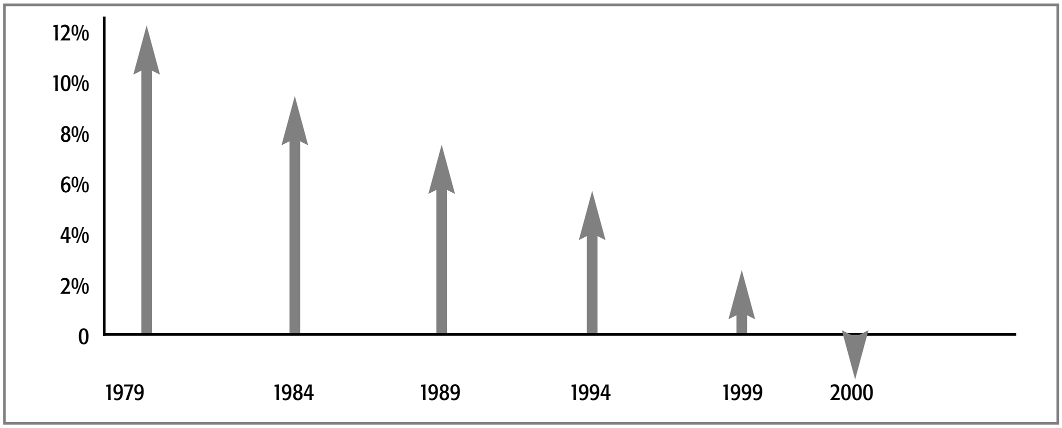


FIGURE 2.1 Savings Rate as a Percentage of Income *(Source: Bureau of Economic Analysis, 2003)*

beginning to be felt. An article in *USA Today* in May 2002 stated the number of home foreclosures is at the highest rate in 30 years, according to the Mortgage Bankers Association of America. The article went on to quote Samuel Gerdano at the American Bankruptcy Institute as saying "personal bankruptcy levels have reached a new national record."

In my practice as a financial advisor in Long Island, New York, I have seen this firsthand. Figure 2.2 shows debt as a percentage of national income. From 1999 to 2004, a veritable home refinancing boom has run parallel with a real estate boom. This twin boom was partly fueled by record low interest rates and one would

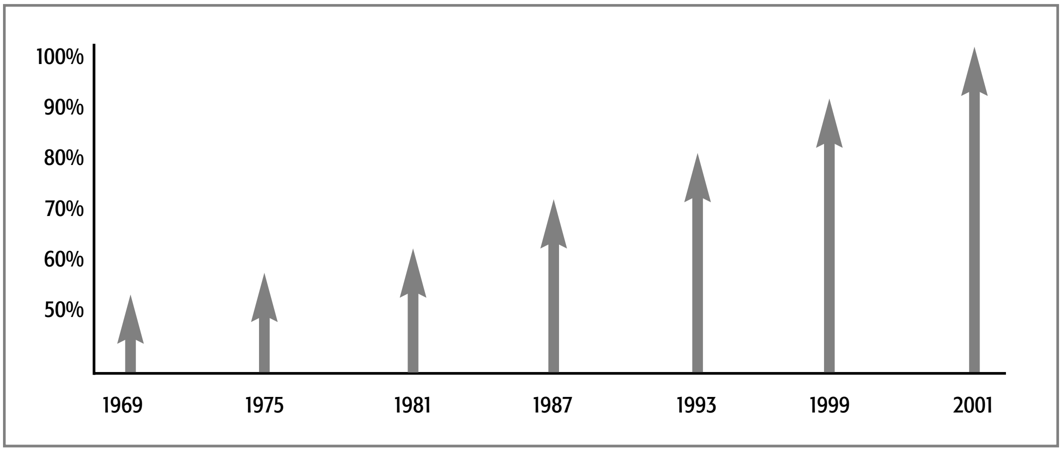


FIGURE 2.2 Debt as a Percentage of National Income *(Source: U.S. Federal Reserve System)*

think that as a result, people are getting wealthier, reducing debt, and increasing equity in their homes. Although a number of people have done exactly that, the majority actually dug a larger hole for themselves. Flush with cash, lenders have financed up to 90 percent or more of home values and relaxed many income rules and ratios. Consumers, instead of using lower rates to reduce payments and put aside the difference, have increased their debt by using the new funds for swimming pools, cars, and vacations. One of my tax clients, against my advice, sold his comfortable house and purchased a new luxury home. Sounds like fun until you realize that he's only able to make payments because of overtime at his UPS job. He's a 51-year-old boomer with minimal savings, making no contributions to his 401(k).

The conclusions are inescapable, especially for the baby boomers:

> *Zero saving rates coupled with high debt levels will result in negative cash flow unless individuals take action to reverse this sad trend.*
>
> *If individuals do not reverse this trend, they will find themselves forced to continue working through retirement, often in jobs they do not want. The results of a survey published in the December 2002 AARP magazine,* Modern Maturity, *indicate this is happening right now: an appalling 76 percent of retired people still working stated they are working because they "need the money!"*

Although the facts overall are depressing, the message I bring you is one of hope. By following the strategies in this book, you can reverse the trend for yourself and your family. It can be done individually, one person at a time. That's why I wrote this book.

The question now is, where do you stand? Turn to the Worksheet Section in Part III and do Worksheet 1: Thumbnail Sketch Worksheet (page 218). It's a beginning and will give you a quick idea of where you are financially and how well prepared you are for retirement. In the next chapter, you will work through a more detailed worksheet and put together a basic financial plan for your retirement.

HAL AND MARY AND PETER PAN

I have two beautiful granddaughters ages nine and seven. Along with tax and financial texts, I buy lots of kids' DVDs and books. Two years ago, thanks to Disney Studios, I rediscovered Peter Pan with my granddaughters. As I watched the DVD for the umpteenth time (they never get tired of it), I was struck by the metaphor of the movie and how it applied to clients I had advised.

In his magical world, Peter Pan never grew up, never matured. Not only could he fly, he never grew old. Well, Hal and Mary can't fly, and they most certainly grew old. But their financial lives never grew up, never matured. They didn't save, invest, plan, or use any of the techniques and strategies in this book. Their financial season remained firmly in the spring while their bodies entered winter. There is no never-never land for people in their situations, and the realities soon hit home.

My firm had been preparing Hal and Mary's taxes for the previous five years. Even though I had mentioned it to them several times, Hal and Mary had never invested or done any business with us outside of tax preparation. A few months ago Mary called me and asked if she and Hal could sit down and talk and perhaps do some planning.

A few days later we met in my office and the story unfolded. Hal worked for automobile dealerships his whole life. He was 69 years old, and Mary was 66. Until recently, Mary had never worked outside the home. They have three grown children and eight grandchildren. In the 1960s and 1970s, Hal jumped around in jobs quite a bit, working at several auto dealerships throughout Long Island. During those years, most automobile dealerships did not have pension plans, and the ones that did have them had long vesting and eligibility periods. Hal never seemed to stay in one place enough years to build up any serious pension savings and did not save much anywhere else either. In the mid-1980s, the couple's three kids had all grown and left the nest. Hal and Mary decided to pursue their dreams and move to Florida. They sold the house on Long Island, realized a nice profit, and used it to buy a house in Florida for cash.

It took about ten years for Hal and Mary to move back to Long Island where all three of their children had settled. The lure of family, and especially grandchildren, proved greater than that of the sunshine state. Because New York housing prices had grown faster than Florida's, Hal and Mary had to take a modest mortgage to buy a condo in a nice retirement community in Suffolk County. That was about eight years ago, and the couple began to face difficult times. Even though Hal was now less than six months away from 70, he continued working because they needed the money. Precious little savings, no substantial retirement assets, and Social Security as the only source of income meant Hal had to keep working. Only now his health was declining and he could no longer meet the physical demands of his job. Mary could only get part-time work at minimum wage.

This is the part of my work that I hate. I wrote this book to help people avoid having to sit across from someone like me in the future and having to pick from a handful of unpalatable choices. I felt like the doctor who discovers a tumor in a patient and knows it's a death warrant.

The choices were precious few. They didn't want to move in with their kids and could not ask for their help because each family struggled with its own financial problems. They didn't want to move away from Long Island again, yet the cost of living was impossible for them. The solution I helped them decide upon was the best of bad choices: a reverse mortgage that would give them an income while at the same time wiping out the small mortgage liability they held. The problem was that the reverse mortgage would eat up their equity in the home, and if Hal and Mary lived to their expected lifespans, there would be precious little inheritance for their kids and grandkids, which hurts them very much. The sad reality is that this solution provides only temporary breathing room. If there is a surge in inflation, they will be in trouble again.

Hal and Mary are living proof for the absolute need to think differently, to become a retirement revolutionary, and plan your financial life in the Age of Longevity.

WHERE DO YOU STAND: A THUMBNAIL SKETCH

As you complete Worksheet 1, keep in mind that it's okay to use approximate figures. The purpose of this worksheet is to give you a quick idea of where you stand. In later chapters, you will use precise figures and develop exact strategies leading to wealth acquisition and financial independence. Right now you just want a quick idea.

How did you do? Are you about where you thought you would be, or are you surprised, maybe even shocked? If you did well, continue on; your task is to manage, grow, and protect your financial life. If you did so-so or terrible, here's the message you should come away with:

It doesn't matter!

Sure I'd rather have come out well at the onset, but that's not what's important. I've counseled plenty of clients who had substantial amounts, yet lost them for various reasons. Here are the two things that really matter:

1. That you get started.
2. That you stick with it.

If you do, I promise you will succeed. The ideas and strategies in this book are time-tested and specific. You will know exactly what to do and when to do it.

You can only fail if you don't get started or don't stick with it.

"Well begun is half done." —Aristotle

CHAPTER

3

Getting Started the Right Way

In 1962, I was on the track team for Sewanhaka High School in Floral Park, Long Island, New York. My specialty was the 50- and 100-yard dash, and the coach was Big Jim Fraley. He was a rough, tough, cursing, cigar smoking, ornery man who kept his love for educating young people hidden in plain sight. He taught me an important lesson in life that has served me well over the years and I want to pass it on to you.

One afternoon, unsatisfied with my performance, Big Jim had me on the starting block for half an hour. When he was finished, I could wind my body like a coiled spring on that block. When the starter pistol went off, I would explode off the starting line, gaining that precious split second that meant the difference between winning and losing.

"Son," he said at the end of that session, clouds of pungent cigar smoke swirling about his head, "You just remember a good start is the key to everything in life."

Thanks coach, I never forgot that.

This chapter will get you started, started the right way.

LEMONADE FROM LEMONS: WAYNE AND LORI

I met Wayne and Lori on the tail end of their financial train wreck. It was December 1987, and the couple had reached their mid-40s. They had one son in college on a full scholarship, with minimal expense to them. Wayne worked for KeySpan (an energy company) as a manager earning a good income and benefits, while Lori worked part time. They had a goal to build enough assets in addition to Wayne's 401(k) plan so they could retire on his 55th birthday. Although they had been doing well, saving and investing aggressively, the aggressive part got them in trouble. As the markets reached new heights in 1985 and 1986, they experienced success with their brokerage accounts. They remortgaged the house in late 1986 and threw the proceeds into the stock market, making more aggressive purchases, enthusiastically encouraged by their broker. Their account hit $330,000 in the summer of 1987, and they started talking about even earlier retirement.

Nothing lasts forever. Parties end; bubbles burst. When the stock market crashed in October 1987, Wayne and Lori held large baskets of options heading the wrong way, overpriced stocks, excessive margin positions, and some commodities accounts. In one week, their portfolio value dwindled to a little more than $80,000.

They were sick to their stomachs. They blamed each other and kept going over dozens of what-if scenarios. They looked to me for guidance, to undo the damage, and to set them back on the road toward affluent retirement.

I told them to abandon all hope of improving the past. I suggested that no one is able to move ahead while looking backward. I wrote a plan for Wayne and Lori, the same plan that is in this book for you. Three years later, they were well on the way to recovery. In 1994 we set a new goal to achieve financial independence by 1999, and welcome in the Millennium in Orlando, Florida, at the Disney World celebrations.

On New Year's Eve 2000, celebrating their freedom and financial independence, Wayne and Lori counted down the New Year at the Universal Studio compound in Orlando. Wayne was 58 years old, and Lori was 56. Now here's the really good news:

You can do it too. It's logical and scientific, so let's get started.

Okay, right about now you may be thinking, "Oh no, not another dreary worksheet exercise, more boring than watching a chess match, with the numbers coming out numbing and incomprehensible, telling me I'll have to work until I'm 90 because I'm financially incompetent."

That couldn't be farther from the truth. While clients learn from my advice, I also learn from them. I learn about human motivation, needs and desires, and the psychological process leading to wealth and financial independence. One of the principal things I learned over the years is that if a plan is too complicated or requires people to change significantly and suddenly, it just won't work. Sure, a person may initially get fired up about the plan, but after a while the pull of old habits begins to win, retaking lost ground because the change is too sudden and too jarring. Pieces of the plan are delayed or ignored, and ongoing planning is soon dropped. Before you know it, you're right back where you were, goals forgotten, heading away from financial independence.

That's why I devised the 10 Percent Plus Solution. Coupled with basic money awareness, it guides the reader toward the achievement of financial goals with little change or effort and no struggle.

The first time I met Charlene, she spit up on me. It was in late winter 1978, and she was just a few months old. Her parents were my clients, and had brought her into my office. She was cute as could be, so I wanted to hold her. Yuuk!

Twenty-two years later, Charlene walked into my office. She reminded me of my own daughter, poised, smart, and beautiful. When I saw her and realized who she was, I had one of those moments when you suddenly become aware of the passage of time. Clients that I had first met when they had no kids, now had grown children who were becoming new clients themselves. I guess time really does fly when you're having fun.

Charlene had been married less than a year to a nice guy named Jim. They were DINKS (Double Income No Kids.) Charlene came to see me because she was worried about money. Jim earned a good income in construction, and she worked in the administrative department of Stonybrook hospital. So what was the problem? They had received a fair amount of money at their wedding and now, less than a year later, it was gone. Even worse, they were starting to build up credit card debt, living from one paycheck to the next with no savings. They were planning to buy a house and have a baby, but money just seemed to disappear as it does for so many folks.

The problem was that Charlene and Jim, like so many other people, had no money awareness. How could they? It's not taught in schools and colleges, although it should be. And our daily life is filled with marketing powerhouses designed to keep you spending, thereby helping to destroy any useful money awareness a person may have.

Over the next few weeks I gave Charlene and Jim a basic course in money awareness and started them on the 10 Percent Plus Solution. By the start of 2004, they had moved into a ranch house in Smithtown, Long Island, and had a baby. I suspect the second will soon be underway. Jim still works construction, but they are no longer DINKS with Charlene working only part time from home doing medical transcription. They no longer live from paycheck to paycheck even though their income has dropped a bit, and they have savings and a college investment plan for the baby. They didn't win Lotto or inherit anything. They're just plain nice ordinary people you see everyday by the thousands.

So how did they do it? Simple, they developed money awareness and worked on the 10 Percent Plus Solution. It's not complicated, it works for everyone, and it's within the grasp of each and every person reading this book.

MONEY AWARENESS

This is the starting point. As the tire commercial used to say, "Its where the rubber meets the road." It's not complicated or difficult. It's just a painless way of changing your thinking, your concepts, with little effort.

There are many kinds of awareness, and they populate our days. We are aware of speeding automobiles as we cross a road, so we are careful to look both ways. We are aware of temperatures, so we choose our clothes accordingly. We are aware of being hungry and thirsty, so we plan our meals. Various kinds of awareness fill our days, but how about money awareness?

If you are reading this in the morning before going to work, you probably know what you will wear, where you will have lunch and perhaps even what you will eat. You are aware of how you will get to work and generally what you will do on the job. You maintain awareness of so many daily details, but how about money? Do you know what you will spend today, what you will spend or save during the next few days and weeks? Will it be well spent? Could you do better? That's money awareness.

People will often confuse money awareness with money worries. People spend much time concerned about how bills will be paid, how they can afford the car they need, how they can possibly retire, and a host of other money worries. That's completely different from money awareness, because those same people may spend their days unaware of the flow of money and the financial and psychological dynamics of numerous daily money transactions in their lives. They are left with health- and relationship-destroying money worries, and no direction on how to improve. The paycheck-to-paycheck treadmill continues. You can get off that treadmill with money awareness! Start with four easy steps.

Step 1: Know Your Enemy

Know your enemy and know yourself, and you will win a thousand battles.
—Sun Tzu, *The Art of War*

Your enemy is a triumvirate of powerful forces in our society. Once you understand them and begin to filter your financial life through recognition of these forces, you will be on your way to financial independence. These three forces—manufacturers/merchants, creditors, and media/advertisers—act in concert, intertwined in their ceaseless efforts to keep you in debt. I am not saying these forces are evil. They are simply doing what they were created to do. It is your job to resist and use them wisely if you are to reach financial independence.

MANUFACTURERS/MERCHANTS. They perform a crucial function in our society, that of making and dispersing the things we use in our lives. Their job is to make sure you buy as much of their stuff as they can convince you to buy, rather than as much as it is *wise* for you to buy. That's a crucial difference. They are not charged with your financial well-being, that's your job, and no one else will do it but you.

CREDITORS. Those are the banks and finance companies that lend us money to get the stuff the manufactuers/merchants make. Sometimes, we need them. There are necessities we can only get on credit. But consider this: your financial health is not their concern no matter how much they say they care for you. They really don't. Their job is to sell you as much credit as possible, to keep you in debt forever, paying interest endlessly. Your goal should be to eliminate all debt as soon as possible; that's the only way you can be truly financially independent. The creditors' goal is the complete opposite. Their only restraint will be your ability to pay, not your financial independence. They are not concerned that you will run in place financially your entire life and never get ahead.

MEDIA/ADVERTISERS. Their sole concern is selling the manufacturers'/merchants' stuff and the creditors' services. They use everything in a powerful psychological arsenal to accomplish their goal. Sex, love, greed, the allure of youth, and the illusion of happiness, everything is thrown at you through the power of the media: television, radio, print media, blockbuster movies. People are constantly steeped in messages, driving them to excess consumption and keeping them from true financial independence. Sometimes it's hard to resist. Only by understanding the powers at work and putting your own goals ahead of theirs can you truly win.

From now on, as you go through your day, be *aware*. When you see an automobile commercial proclaiming that you can own this auto for only $300 per month, be aware of the forces at work. Look around you. Understand their motivations and put your financial independence ahead; only on that road will you find the peace of mind that financial independence will bring. Next time you feel a twinge when you see a commercial, instead of picturing yourself in the action using the product, picture yourself writing the monthly check, working the overtime, and staying on the job past retirement age. Kind of tarnishes the image, doesn't it?

Step 2: Examine Every Financial Transaction

It doesn't matter what kind of transaction or how much money is involved, examine every financial transaction. It takes no time at all, and soon it becomes a habit. Buy a cup of coffee and a pastry in the morning, feel the dollars as they leave your wallet. Feel them entering your grasp, and be aware. Feel the money being relinquished to the cashier. Be in the moment. Understand what you have spent, what it takes to get that money in your wallet or purse in the first place, and what you have received in return. Perhaps the pastry should be skipped in favor of your waistline and wallet? Do a quick second thought. Now think about how that money would bring you just that much closer to financial independence, to the day where you no longer need to report for work because your cash flow comes from your own assets. You will be amazed at how much money can be saved each week by just applying this basic principle every time you reach for your wallet or purse.

Step 3: Plan Your Purchases, and Use a Cooling-Off Period

Okay, you're not going to plan buying a cup of coffee. You just need to be aware of money leaving your purse and what you get in return. But what about other purchases, like a pair of shoes, a coat, a car? Plan. Plan. Plan. The greater the purchase, the more planning you should do. I know, I promised it would be easy, and it will be. No need to make yourself crazy. Just think for a moment. What kind of shoes do you need, how much will you spend, and where's the best place to get them? Can your purchase wait for a sale? Give it two or three minutes, maybe five if you go through the paper looking for a sale. That's all it takes. Your primary purpose when buying should be the same as for the actors in the telephone commercial: "Save a buck or two."

Be very aware when it comes to large purchases like appliances and cars. Before you step into that showroom, you will have been subjected to the enormous power of advertisers through all sorts of media. When you enter a showroom, you will be the focus of intense sales training and enormous psychological pressures. One of my clients owned a large automobile dealership in Long Island, New York, and I had the chance to view firsthand his immensely successful strategies. Three simple methods are used to persuade and coerce millions of people into overspending and creating a debt burden that prevents financial independence. There are ways to fight back using your new awareness, especially if you understand these techniques.

They soak you into the product to fire up your desires and destroy your common sense. "The feel of the wheel makes the deal" was my friend's favorite saying. Salespeople were trained never to discuss prices or specifics until the prospect had driven the car and could taste the ownership. Second, they boil it down to the ridiculous to make it "affordable." So $589 per month becomes $19 a day. You can afford $19 a day right? Third, you are hit with a sense of urgency that is entirely false. This model will soon be gone and this great $19-a-day deal will disappear forever if you don't act now. Funny, those same people still own the dealership, and the deals are still there every day.

Fight back! Use your money awareness. Understand that $19 a day is $589 per month and that since this was a five-year loan, the total cost is $35,340. If a less expensive model was purchased as a year-old "demo," the total cost over a three-year loan would have been $23,460. The new car smell will wear off after a few months, and you will be left with the years of payment. If the new car smell is that important for you, buy a can of it at AID Auto stores for two bucks and spray your interior every three months. When you think about saving over $10,000 on a major purchase, consider that:

> *$10,000 invested in the Franklin Growth Fund (not even a top performer) in January 1967, 25 years later in January 1992 would be worth, $517,655.* —Source: Prospectus for Franklin Growth Fund, May 5th, 1995

One wise decision made by a 25-year-old in 1967, would have resulted in half a million dollars at age 50, a certain boost toward financial independence.

Plan, figure out what you need and what you want, understand the cost and what you are willing to pay, and stick to it. When the salesperson pressures you, your new money awareness will bring a slight knowing smile to your lips as you say "I'll get back to you in a couple of days."

Use a cooling-off period. Drop the whole thing, make your final decision two days later, and never deviate from it. Resist the urgent, "today only" sales pitch. Trust me, the deal will still be around next week.

Step 4: Record and Separate Every Saving, No Matter How Large or Small

This is the last crucial step before embarking on the 10 Percent Plus Solution. It is the key that opens the door to financial independence. When your newly developed money awareness saves you one dollar, put that dollar away. If it saves you $10,

$100, or $1,000, put these dollars away in a separate savings account. That account will be your 10 Percent Plus Solution account. Remember, before you developed money awareness, you would never have had those dollars.

THE 10 PERCENT PLUS SOLUTION

Like country and western singer Johnny Paycheck said in one of his songs, "Take this job and shove it!" Don't you get that feeling sometimes, that you'd just like to tell them all to shove it: the bosses and supervisors, the customers, the commute, the hassles? Even if you love your job, don't you occasionally get a twinge for other horizons, for the freedom to go where you want and do what tempts you, with no regard for the need to show up for work five or six days a week at a specific time and place? Well, keep on reading, because I've got great news for you. The 10 Percent Plus Solution will get you there without fail. I have used it myself and for my clients for decades, and now I have put it into an easy-to-use plan that will work for you. I don't care whether you are an executive making six figures (and spending six and a half) or a working person struggling to survive just above the minimum wage. The four steps you just read, followed by the 10 Percent Plus Solution, will bring you to a place where your income will come from sources other than your labor. The 10 Percent Plus Solution starts with two simple goals:

1. By using money awareness and the four-step process above, put away 10 percent of your income each month into your account.
2. Increase your income in your occupation, by 5 to 10 percent each year. Add the additional income to your 10 Percent Plus Solution account.

I can't give you the specifics of how to increase your income each year, because it's different for everyone. But I can tell you that if you set that goal, if you work at it, you will find the way to achieve at least part of that increase, perhaps even exceed the goal. Whether you reach it or not doesn't really matter. The important things are that you set the goal and you tried. Keep on doing that, and one day you will find that the mental process of setting that goal will lead you to success. To help you in reaching your goal, I recommend *The Goals Program* audiotapes by Zig Ziglar available from Nightingale Conant at (800) 527-0306.

The result of striving to reach these goals will be an ever-increasing account. The next chapters will tell you exactly how to use that account to eliminate debt, build portfolios of investment, set up multiple streams of future income, and eventually achieve financial freedom. Chapter 14 outlines plans for reducing income taxes. Remember, every penny you *would* have given to the IRS should find its way into your new account.

How long will all this take? It varies with everyone, depending on a number of factors such as how much debt you have now, how much income you have, and how willing you are to apply the principles in this book. However, I can tell you this; no matter what the current situation, average working people can achieve financial independence faster than they think they can. I have seen it many times, and over the years have guided many people along this path. I firmly believe you can do it.

There's a great book out by Thomas J. Stanley and William D. Danko called *The Millionaire Next Door: The Surprising Secrets of America's Wealthy* (Simon & Schuster, 1996). Without stealing Stanley and Danko's thunder, I will tell you the two great secrets of the millionaires next door.

First, they are for the most part, people just like you. They are nurses, laborers, clerks, truck drivers, bricklayers, teachers, police officers, accountants, merchants, salespeople, plain average folks,who never earned six figures. They live in average houses and drive average cars, and some of them probably live in your neighborhood, on your block, maybe even next door. They may be working, but you can be sure that if they work, it's because they want to, not because they have to.

The second secret is how they did it. In one form or another, they applied the principles I just showed you in the four-step process and the 10 Percent Plus Solution. They have good money awareness and live a little below their means, putting a bit of today away for tomorrow. For them, tomorrow has arrived, and they are financially independent, living the kind of life that only financial freedom can bring, the kind of life you will have if you follow the advice in this book.

FINDING OUT WHERE YOU ARE

Ever see one of those maps in tourist spots with a legend saying "You Are Here" and a big X marking the spot? The reasons for this are obvious. It's impossible to get where you want to go unless you know where you are. That's what this exercise is all about, figuring out where you are financially so you can get where you want to be. This is a starting point, a quick and dirty exercise designed to give you an approximate idea of where you are and how far you have to go for financial independence. In the Worksheet Section of this book, you will find more detailed exercises, but for now, this will give you a good starting point.

So how much income do you need to retire and be financially independent? There are so many factors that it's almost impossible to determine accurately, but here are some questions to consider. Will the kids grow up and leave early or will they attend colleges for four, six, or eight years? Will you continue to live where you are or move to a less or more expensive place? Because there are so many factors, the best starting point is your current income. If you are reasonably happy with the income you have now, use that as a starting point. Don't assume that because you will be retiring, your income needs will drop significantly. They may, but don't count on it. If you feel you will need more income than you now have, figure out how much more you can reasonably expect and use that figure.

What is the amount needed to generate income? Suppose your current income is $41,000 per year and you are reasonably satisfied with that figure as retirement income. Using a rate of return of 5.5 percent (page 224 explains how to arrive at that rate), here's the calculation:

$41,000 divided by the rate of return 5.5 percent as a decimal, or
$41,000 divided by .055 = $745,454

Now fine-tune that a little bit for your own situation. First, look at sources of current income not derived from work, income that will continue steadily. Perhaps you have rental income from an apartment in your home or a rental house you own. Any source of income that will continue whether you work or not should be deducted from the current income.

Next, deduct any future guaranteed retirement income. If you are approaching retirement age, include anticipated Social Security benefits. If you expect a pension in a few years, use that figure to reduce needed income.

Now let's do the calculations for a hypothetical baby boomer, although it will work just fine with anyone at any age. Joe Boomer is 50 years old, and his wife Jane is 48. He is a county worker with 18 years on the job and will be eligible for retirement at age 55. His anticipated pension income from the county will be $19,500. Both kids have left the nest, and Jane works part time. The couple's combined income is $48,000, and they are satisfied with that income. Since the kids have left, Joe is converting their rooms into a separate apartment that they expect to rent for $650 per month. Suppose they have managed to save $165,000. Here is the initial calculation to see if Joe can be financially independent, at age 55.

Income need:	$48,000
Less pension	$19,500
Less rental income (650X12)	$7,800
Income need at age 55:	$20,700

Amount needed to generate $20,700 of income:
$20,700 divided by .055 = $376,364

That means that Joe and Jane must raise an additional $211,364 in addition to current savings of $165,000. Sounds like a lot, but I would bet they can do it. Using money awareness, the four steps, and the 10 Percent Plus Solution, there's no doubt it can be accomplished. As their money awareness grows and they apply the 10 Percent Plus Solution, their income needs will decline and money will flow into their investments and accounts. Chapters 5 through 8 outline how to build portfolios of assets aiming for double-digit returns. With the magic of compounding and the 10 Percent Plus Solution, Joe and Jane will be able to close the gap in five years.

To figure out what you need for retirement/financial independence go to the Worksheet Section and complete Worksheet 2: Finding Out Where You Are—Season of Money (page 220). In the following chapters, you will receive recommendations specifically targeted for your season of money.

At this point I often hear the comment, "This is impossible. I'll never get there, I'm just too far away." Nonsense. Let's get back to the example of Joe and Jane Boomer, where the retirement asset need was $211,364. You might wonder, where on earth will a 50-year-old get that extra money and retire financially independent at age 55? I repeat:

When the student is ready, a teacher will appear.

There is more to this than a simple financial equation, there is the call of your desires, the things you always wanted to do, the dreams stomped down by lack of guidance, and above all, belief.

You see Joe and Jane Boomer are real people. I have known them for many years. I helped them with their taxes, advised them on investing options for Joe's supplemental savings plan with the county and their other investments. They did okay, but didn't save and invest quite as they should have. I was the teacher, and although I had been there all along for them, they had not been ready, so I hadn't really "appeared" for them. Now, just a few years from retirement and not yet financially independent, they were "ready students." We began seriously planning for financial independence.

I taught Joe and Jane money awareness and got them started on the 10 Percent Plus Solution. It helped, got them seriously going in the right direction, but still it wouldn't be enough to cover the cash shortfall. And Joe wanted to retire; he had grown to dislike his job. We planned for Joe to retire on schedule and close the gap with part-time work. But this time, it would be different. Joe would set some goals, seek an occupation that appealed to him, and after searching for the better part of a year, found it right around the corner.

Joe retired from the county and started working four days a week at a hobby shop. He had always been fascinated by remote-control model airplanes, model rockets, trains, and other hobbies, but never actually engaged in any of these activities. Now, closing in on the end of his 56th year, he found himself immersed in all these things, and he loved it. We sold some of Joe's mutual funds and he became a 50 percent partner in the hobby shop. While the hobby shop is not exactly a gold mine, it is profitable and closes the cash gap very nicely for Joe and Jane. They continue to scrupulously apply money awareness and the 10 Percent Plus Solution. We expect them to reach complete financial independence within the next two to three years.

Most important, the couple has found the nonlinear way. They are living as I believe we are all meant to live—happy and fulfilled. Both have the time to be very involved with their three grandchildren. Jane does various volunteer work, gardening, maintains the household, and helps out at the hobby shop. As for Joe, well, this is what he said to me the last time we met to review his finances: "Every day is like Christmas morning for me. I can't wait to get to the shop and see if the latest models we ordered came in. Maybe I'll put an airplane together, try it, and send a 'flight report' to our customers. It's great, I love this stuff."

The process works for everyone in all cases. None of the examples I have used are PhD's, lawyers, doctors, heirs, heiresses, or Lotto winners. They are just plain ordinary folks like most of us, ordinary folks who rose to extraordinary circumstances with a simple three-step process:

1. Develop money awareness.
2. Apply the 10 Percent Plus Solution.
3. Set and track financial goals.

That's it; that's all it takes to achieve financial independence in the Age of Longevity. Remember Chapter 1: Perception is reality. Your goals and mind-set will create the perception, and your brain will subconsciously seek and find the answers.

Now for the most important thing before we end this chapter. What about people who have no savings, are loaded with debt, and can't seem ever to get ahead? You need this book more than anyone else.

Don't despair. You can pull out of it. Develop your money awareness, follow the four steps, adopt the 10 Percent Plus Solution, and then go on to Chapter 4 where I show you how to be debt free in five years or less. Continue on to the Mortgage-Buster Solution and Chapter8 on building portfolios for pennies a day. Stick with it!

It may take you longer, but you will succeed. I have seen it time and again. Don't get discouraged. It's a proven system that always works.

Be sure to go to the worksheet section and complete Worksheet 2: Finding Out Where You Are—Season of Money. Repeat this exercise at least once a year to track your progress and update your strategy as you progress through your financial seasons.

Progressive Plan of Action

At this point, you have accomplished the following:

- Developed the confidence to understand that you can achieve financial independence, that perception is reality, and that you cannot fail.
- Used money awareness and the four-step process, to set the goal of putting away a minimum of 10 percent of your income each month.
- Set a goal to increase your income by 5 percent to 10 percent each year.
- Adopted the 10 Percent Plus Solution and are ready to open the accounts described in the following chapters.
- Worked through the exercises in this chapter and understood where you are in your season of money.

"I owe, I owe, so off to work I go." —Unknown

CHAPTER 4

Dealing with Debt

At a long-ago seminar on overcoming procrastination, I learned something that I follow to this very day: if you have a number of things to do, start with the one you like the least or that appears to be the most difficult. As I applied this principle, I discovered that what I had seen as very tough to do was not as hard as I thought, once I got started. After this difficult task was accomplished, everything else seemed easier. Other tasks flowed smoothly once the perceived difficulties were removed. I guess it's basic human psychology that fears are magnified in our minds, but are never as bad as we believe. So in that spirit, the first thing we're going to tackle is debt.

HOW MUCH DEBT IS RIGHT?

Ideally, zero! In fact, that's what we're going to aim for eventually, so by the time we reach financial independence, debt will be reduced to just about nothing. But we have to be practical. We need a car to get to work, a house to live in, furniture, things for the new baby, and cash for the new refrigerator because the old one is shot. In the early working years, debt cannot be avoided. The trick here is to keep your debts to the necessary minimum and get rid of them as soon as possible. To do this successfully, you must be able to tell the difference between *needs* and *wants*, between *assets* and *liabilities*. You may think that you already know this. You may know it intellectually, but that is just not enough. There are plenty of very smart people out there who understand the meaning of these words, but wind up in bankruptcy court or so riddled with debt that a financially secure retirement will never happen for them. Just knowing the dictionary meaning of those four words is not enough. I want you to understand them deeply, on a primeval level, like a caveman hearing the growl of a saber-toothed tiger deep in the night. I want that meaning to rear its head each time the triumvirate, the enemy from Chapter 3 determined to keep you in hock for life, presents yet another debt opportunity you don't need. I want your gut-level understanding of needs-wants-assets-liabilities to overcome the siren song of live for today and pay tomorrow, because it's not pay tomorrow, it's pay and pay and pay, tomorrow and maybe forever.

Need

A need is something we must have to survive, like air and water. Needs include a nice place to live, an automobile, nice clothes, education for our children, jewelry for our egos, and entertainment and vacations to soothe our spirits and recharge our mental batteries. (See, maybe I'm not so Spartan after all.)

Fulfilling needs is costly but it must be done. No financial plan can survive if it cuts into the needs of a family. Planning for financial independence must encompass and embrace the fulfilling of needs.

Wants

Wants can also be needs. We may live in an apartment but want a house for our family. We may drive an old car that constantly jeopardizes our jobs by breaking down on the way to work. We need and want a newer car.

But wants can be insidious. Wants have a habit of sneaking into our dreams and growing and becoming the second driving imperative that will snuff out the original dream of financial independence. Like the 500-pound gorilla that cannot be ignored, wants have a way of taking over. How we manage our wants will spell success or failure for our goal of financial independence in the Age of Longevity. In the final analysis for those seeking financial independence, there will always be some sort of compromise, some give and take between needs and wants. The lines are not always clear. There is a gray area, a blurring of the distinctions as to when a need becomes a want and how far should each one of us go past fulfilling a need toward satisfying a want. It will be different for each one of us. It will even be different for individual members of the same family. However, here is the one thing you must do when considering a want/need:

> *Determine exactly how funds diverted to a want will affect the ultimate goal of your plan toward financial freedom.*

You will see that planning requires a certain amount of dollars saved and invested in various areas. You will determine how many assets you need to build, how frequently to invest, how much to reduce liabilities, how much return you must have, and the time frame appropriate for your system.

Once this initial planning is completed, it will not be difficult to determine the effect of satisfying a want. Perhaps buying the Lexus means reaching a goal at age 63 instead of age 55, whereas buying the Toyota Camry will not affect the plan at all. When you factor in such an effect, it is sure to influence your buying decisions.

As a good financial advisor, and I am one of the best, I never attempt to tell my clients what they should or should not buy, or how they should live their lives. That is something that, first, I feel it is not my place to do and, second, it will not be taken, no matter how sound, unless it comes from them.

I do insist however, that they understand the financial impact of their decisions in a black-and-white cold numbers way. People often delude themselves as to the real financial impact of a want purchase. It's my job to make them face reality, or as William Shakespeare wrote:

> *To thine own self be true.*

Here is an example of what I would tell a client, something that must be done each time you are faced with a want decision.

> *John and Mary, I have calculated that buying the vacation condominium will set back John's plan to open his own business by six years. On the other hand, if you simply keep the time-share, our plan for business funding will stay on track. If you are okay with delaying your plans by six years, that's fine as long as you understand that's what you are doing and that's what will happen.*

That was a real conversation with real clients. No, they didn't buy the condo.

Liabilities

Liabilities, such as a mortgage, can also be needs as can tangible things like automobiles. Debt in all forms is a liability, and all liabilities have certain characteristics.

- While liabilities can be needs, like a mortgage, they are often the result of wants, such as not paying down a mortgage because of payments on a luxury item. (That's a double liability.)
- Tangible liabilities such as autos and luxury toys usually have relatively short lives and continuing ongoing additional expenses such as insurance, repairs, maintenance, storage, etc.
- Tangible liabilities usually depreciate, that is, lose much of their value over time. (Please don't tell me about the '55 Chevy you had back in 1960 and how it would be worth a gazillion dollars today. You won't reach financial independence by buying and keeping a car for 50 years.)
- Intangible liabilities can have long lives, for instance, mortgages and other forms of debt not paid down.
- Liabilities, if not eliminated during your life, are passed on to future generations with negative results.
- Liabilities and their effects never die out by themselves. It takes a conscious effort of will to eradicate them.
- Liabilities destroy wealth.
- Liabilities gobble up income.

Assets

Assets can also be needs. Some assets are easy to understand, like a portfolio of mutual funds or a house. Sometimes, the lines between assets and liabilities become blurred. However, assets, like liabilities, have certain distinct characteristics:

- Assets such as a house or a vacation cottage that is sure to go up in value over time as a real estate investment can also fulfill needs.
- Assets have long lives, sometimes never ending.
- Assets always appreciate, increase in value. This is the best test of an asset/liability.
- Assets create multigenerational wealth. They can be passed on to your children and grandchildren.
- Assets create wealth.
- Assets usually create income.

For financial independence plan to succeed, it is crucial that the line between assets and liabilities be clear and distinct. The relationship between needs and wants and assets and liabilities must be understood and delineated clearly in planning. How well individuals handle these areas will determine how, when, and even if, they reach financial independence in the Age of Longevity.

HENRY'S DRIVE TO THE POORHOUSE IN HIS MERCEDES

Everyone calls him Henry, but his real name is Enrico. Late one wintry Saturday afternoon as hail and snow peppered the windows of my Shoreham, Long Island, office, he told me an interesting story about growing up in Mexico City.

I'm proud of Henry. He's been one of my success stories. He's the kind of nice, hardworking family guy you just love to see get ahead. He grew up in Mexico, immigrated (legally, with the help of a Good Samaritan-employer in California) to the United States in the 1980s, brought his wife over and moved to Long Island to be near family in Islip. He works in landscaping, always two jobs whenever possible, which on Long Island is almost all the time. I helped him save and invest, and in 1994 he bought a house, a basic ranch in Calverton, for his family that now included two kids and a dog. The landscaping companies Henry worked for were all small businesses with no pension or 401(k) plans. In addition to the savings for the house, Henry invested $166.50 per month in an IRA mutual fund, $2,000 per year, the maximum allowed at the time. With the return of the markets in the '90s, Henry's IRA had grown to a little over $18,000. When you consider the odds stacked against him from the start and the fact that he was just 38 years old, Henry was doing great. That's when he told me his story.

The Mexico City neighborhood he grew up in was desperately poor, the kind of grinding poverty only a third world country can generate. But in that neighborhood was one man who stood, financially at least, above everyone else. He was a captain in the federal police, the *Judiciales.* The man's house was large and modern. It contrasted with the other houses like a diamond among gravel. This police captain, who earned about the same as a Wal-Mart cashier in the United States, also drove a Mercedes. It was very clear that good saving habits and financial planning didn't have anything to do with his wealth, the origin of which undoubtedly came from much darker sources. But in his world, the man's spectacular wealth inspired Henry who made a solemn promise to himself that someday, he would drive a car like that, a Mercedes, and, unlike the captain, he would acquire it honestly.

Now Henry wanted to cash in his IRAs. He had run across a landscaping customer who was selling a four-year old Mercedes for about one and a half times Henry's annual income. I was appalled. It was a singularly bad move from a man who had up until that time been quite sensible, and I couldn't talk him out of it, not even with the remains of my high school Spanish when I told him:

"You'll drive right to *La Casa Del Pobres."* The poor house.

The IRAs got cashed in, and Henry took a loan for the balance. The results were predictable. Costs climbed rapidly, the price of maintaining a Mercedes is far greater than for a Ford pick-up. Insurance costs went through the roof, and the following year at tax time, Henry faced what I had warned him would happen—an extra $5,800 or so in combined federal and New York State taxes and premature withdrawal penalties on the IRA.

Two years later, the Mercedes was sold for a couple of thousand less than Henry paid for it. The emotional acquisition of a liability had set Henry back about five years worth of savings, plus some long-term impacts yet to be played out. Henry had touched his boyhood dream. As so often happens, time had distorted the memory, and the reality was a costly mistake. It is my hope to steer readers away from costly illusions, into the shining reality of financial freedom in the Age of Longevity.

WORKING WITH DEBT

Now return to the original question this chapter started with—how much debt is right?

The answer is the least the better, but in certain seasons of money, it will be unavoidable. So, lets work on that first. In the previous chapter, you worked through an exercise combining income, assets, and retirement income needs. (If you have not yet done this exercise, do so right now. It is important to know where you stand so you can follow the right advice. Go to the Worksheet Section and complete Worksheet 2 (page 220).)

Find your season below, examine your debt level, and follow the course of action recommended for your financial season.

Spring

If the worksheet determines that you have less than 75 percent of assets needed for financial independence, then you are in the accumulation stage, and the idea is to move to the next stage as quickly as possible. Generally at this point, there will be a mortgage, perhaps an equity line or second mortgage, a car loan or car lease commitment, and maybe one or two credit cards. It is imperative to begin holding the line on further debt by using your newly acquired money awareness and the 10 Percent Plus Solution detailed in Chapter 3.

Go to the Worksheet Section and do the exercise Worksheet 3: Debt Load Ratio (page 227) to determine your next course of action. Following the exercise guides you toward an exact course of action that will wipe out your debt in record time and put you on the fast track to financial independence. Of special value are Prosperity Point 1: How to Get Out of Debt in Five Years or Less (page 184) and Prosperity Point 2: The Mortgage Buster: How to Pay off a Mortgage While Keeping All the Tax Advantages (page 187).

Summer

If the worksheet exercise shows you are in your financial summer, congratulations! You're well on your way having accumulated 75 percent or more of the assets you will need for retirement income. The crucial thing that you must avoid at all costs is any further debt. At this point if you own a home, you should have paid down quite a bit on your mortgage and the equity in the home should be well over 50 percent. There should be no other significant debts except perhaps an auto loan/lease commitment.

If your level of debt is still high, then you have the assets to pay it down. At this point, two questions must be answered:

1. Should you take the monthly cash from the 10 Percent Plus Solution to invest and build assets, or should you use it to reduce debt?
2. If you have assets, should you cash them in to pay down debt?

The first step in answering the first question is to assess your cash flow comfort level. How much money do you have left at the end of the month after all the bills, including debts, credit cards, car payments, and mortgage, are paid? At this point, you must determine if you have applied money awareness properly using the four steps described in Chapter 3, and that money is not being squandered.

If you have applied the four steps and month after month you are coming up with zero left over at the end of the month or, even worse, have too much month left over at the end of the money, then your debt level is unacceptable. Go to Prosperity Point 1 and apply all 10 Percent Plus Solution funds to eliminate debt in five years or less.

What should be done if there is money left over, if you're running a surplus at the end of the month? Should you invest and build assets, or should you pay down debt? To properly answer that, you must consider the excess monthly cash as an asset in itself and find the answer by moving to the second question:

If you have assets, should you use them to pay down debt? Use Figure 4.1 to answer that question. Figure 4.1 tells you the guaranteed after-tax rate of return you will get by paying off your debt. Compare this with current guaranteed rates of return. During 2004, guaranteed rates varied between 1 percent and 4.5 percent, depending on the financial instrument. The conclusion is evident for Figure 4.1: Use the 10 Percent Plus Solution for any debt where the interest charged is over the amount that you could earn with guaranteed investments. In Figure 4.1, you

Step 1
Start by finding your tax bracket. Go to your 2003 Form 1040 and find your taxable income on page 2, line 40. (Form 1040A filers, this will be on page 2, line 27.)

Step 2
Find your tax bracket percentage from below:

Single

If your taxable income is	Then your tax bracket percentage is
Between $7,000 and $28,400	15%
Between $28,400 and $68,800	25%
Between $68,800 and $143,500	28%
Between $143,500 and $311,950	33%
Over $311,950	35%

Married Filing Jointly

If your taxable income is	Then your tax bracket percentage is
Between $14,000 and $56,800	15%
Between $56,800 and $114,650	25%
Between $114,650 and $174,700	28%
Between $174,700 and $311,950	33%
Over $311,950	35%

If you live in a state or city that has an income tax, you must add the state/city percentage to the federal. For instance, in New York State, the federal tax bracket of 28 percent would add another 5 percent for a total combined bracket of 3 percent. Find the equivalent tax bracket in your state, and add it to the federal one above.

Step 3
Convert your tax bracket percentage to a decimal:

15% = .15 25% = .25 28% = .28 33% = .33 35% = .35

Step 4
List all your debts and the percentage of interest charged. Do not include your mortgage or any business debt that is deducted on your tax return. You will deal with those later. Here is an example.

Name	*Balance*	*Percent Interest Charged*
Mastercard	$12,850	7%
Household finance	$3,700	6.5%
Car loan	$15,600	1%*

*(manufacturer's incentive)

FIGURE 4.1 Using Assets to Pay Down Debt

Step 5

Apply this formula to each debt to find the after-tax interest benefit of paying this debt off. Assume a federal rate of 25 percent plus a state rate of 4 percent for a total of 29 percent, converted to a tax bracket decimal of .29. Now take the percentages and deduct your tax bracket decimal, 1 minus 0.29 = 0.71. This is your tax bracket factor. Debt interest divided by tax bracket factor equals after tax interest.

Mastercard	7% ÷ 0.71	=	9.86%
Household finance	6.5% ÷ 0.71	=	9.15%
Car loan	1% ÷ 0.71	=	1.41%

If your assets are earnings less than the after-tax interest you are paying, cash them in and pay off the debt.

FIGURE 4.1 Using Assets to Pay Down Debt, continued

would pay off the Mastercard and household finance but not the car loan. Generally, rates of interest on debt will be much higher than you could earn on a guaranteed basis. A few items like automobiles or appliances may have lower interest rates because the manufacturers are willing to cut the interest rate to sell the products. However, please remember that nothing in life is free. Always ask what the price would be if you paid cash.

Consider any special circumstances when paying off debt. One exception would be poor credit. If you pay off the debt with current cash, you may not be able to borrow if an emergency arises. Another exception would be if you are saving for a special purpose, such as the down payment for a home.

How about using investments such as mutual funds, life insurance, IRAs, or real estate to pay off debt? At this point, I would recommend going forward with creating your own financial independence plan using this book. Hold off cashing in anything until you go through the sections involving those investments. More care and planning must be exercised, and as a general rule, never cash in taxable assets like IRAs, 401(k)s, or other retirement plans to pay off debt.

Fall

You've arrived! The worksheet exercises show that you have 100 percent or more of the assets required to provide cash flow for your lifestyle. Job one for you now is to keep your hard-earned financial freedom. Avoid future liabilities, operate 100 percent on cash, and never use credit again. If you have a mortgage, see Prosperity Point 2: The Mortgage Buster (page 187). Any cash reserves beyond the recommended emergency/opportunity fund (see the next section, Emergency/Opportunity Fund) should be used to pay off debt.

EMERGENCY/OPPORTUNITY FUNDS

As you progress through the next three chapters, you will learn how to invest in the stock market and never lose money, how to invest in real estate, how to set up multiple streams of future income, and how to prepare for a lifelong positive cash flow. As you learn these things and make progress putting together your financial plan, it becomes evident that you must invest money for the long term and let it do its work. Having to cash in investments prematurely often results in large losses or the loss of future gains. That's where emergency funds come in.

Conventional wisdom, as taught in the certified financial planner courses, calls for a liquid emergency fund of four month's worth of income. I agree with that figure. The next step in building your financial independence plan is to accumulate an emergency fund. First, determine how much.

Spring and Summer

Back to your Forms 1040, boys and girls! Go to page 1, line 22 (line 15 for 1040A filers), and fill in line 1 below.

Take any annual income you receive on a continuing basis that you use to maintain your lifestyle, but is not reported on your taxes. This could be a nontaxable annuity payment, inheritance, or other income you may not be required to report. It could also be the income you hide from Uncle Sam. (Oh, you cad!) Put that on line 2.

Line 1: 1040 Total Income: ___________________________________

Line 2: Additional income: ___________________________________

Now add up the two lines and divide by three. That's the amount your emergency fund should be. If you do not have this amount, then do one of the following.

If your debt level is uncomfortable, to the point where just paying off your credit cards and other debts creates a shortfall each month, but your credit is good, put off the emergency fund and use the 10 Percent Plus Solution funds to pay off debt as outlined in Prosperity Point 1: How to Get Out of Debt in Five Years or Less (page 184). Continue doing this until the debt is reduced to a manageable level, then apply half of the 10 Percent Plus Solution funds toward building the emergency fund. Continue to apply the other half of the funds toward debt reduction until your home mortgage is all that remains.

If you have debt other than your mortgage, but it is manageable, use one half of the 10 Percent Plus Solution funds to pay off debt as outlined in Prosperity Point 1. Apply the other half toward building the emergency fund. Continue until the emergency fund target amount is reached, then apply all funds toward debt reduction until you only have only your mortgage left. If you eliminate debt first, then apply all 10 Percent Plus cash toward building the emergency fund.

If the only debt you have is your mortgage, apply half of the 10 Percent Plus Solution toward building your emergency fund and with the other half begin the mortgage buster program (Prosperity Point 2).

If you have no mortgage and no debt, way to go! Use the 10 Percent Plus Solution funds to rapidly build your emergency fund, then move on to Chapter 5 to build and manage your investment portfolio.

Fall

Because you have already identified that you have 100 percent of the assets needed to provide the cash flow to maintain your lifestyle, you probably have very little or no debt and your cash flow may come or is presently coming from your assets. If you are working, it is by choice, not necessity. The emergency fund needed is less; about one to two months of income will do. Later chapters will address the most important issues for those who have reached this financial season: securing your income streams and safeguarding your assets. If you have debt, it should be minimal. If it is not, consider cashing in assets to get rid of the debts.

How to Invest Your Emergency Fund

Emergency funds must have three characteristics:

1. *Liquidity*. Funds should be liquid when needed with no penalties.
2. *Availability*. Funds should be available just about instantly, or within days.
3. *Guarantee of principal*. Funds should remain at a stable price without fluctuation. You do not want to have to use your funds, only to find out the market has gone down and you are getting your funds at a loss.

You place your emergency funds in something called *cash reserves*. These are not really investments; they are more of a parking place for cash. The best you can hope for is a rate of return competitive with other such instruments. Historically, cash reserves have failed to keep up with inflation. However, that's the price you pay for liquidity, availability, and guarantee of principal. Here is the important thing to keep in mind:

> *Never put more in cash reserves than you have determined you need for an emergency fund or for some short-term goal, such as saving for a house. Cash reserves are "lazy money" that will not lead us to financial independence. Build up your emergency fund; then move on to investment portfolios.*

Cash reserves for your emergency fund should be in money markets, savings accounts, short-terms CDs (if the interest is high enough to override the penalties for prematurely cashing in).

Specific Recommendations for Cash Reserves

These recommendations are as of December 2004. Check with www. prosperous-boomer.com for any changes.

INGDIRECT, WWW.INGDIRECT.COM, (800) 464-3473. This is an excellent money market that can be linked directly by phone to a checking account for immediate direct deposit upon request to and from the checking account.

VANGUARD MONEY MARKET, WWW.VANGUARD.COM, (800) 662-2739. Vanguard is a low cost money market account with check writing privileges.

FIDELITY INVESTMENTS MONEY MARKET, WWW.FIDELITY.COM. This is a high-yielding money market with check writing from America's largest mutual fund family. However, although the Fidelity Funds are excellent performers and I continue to recommend them, their service appears to have gone downhill and I have caught them making a high number of administrative errors. Investors should continue to use them, but watch their accounts for errors.

A cautionary note to those working with financial advisors: Money markets do not pay commissions to advisors. Some mutual fund families have money market "B" shares where the advisor is paid a commission. However, yields will be less. (Nothing in life is free; the best you can hope for is a fair deal.) When funds are withdrawn, a back end fee ranging from 3 to 6 percent will be applied. Your advisor should recommend only "A" shares in money markets. As your wealth increases, your advisor will realize commissions from mutual funds and stocks as you build your portfolio.

Progressive Plan of Action

At this point, you have accomplished the following:

- Made certain you have completed the first section of the Progressive Plan of Action outlined at the end of Chapter 3.

- Started (or already accomplished) a systematic plan to eliminate debt.
- Started (or already accomplished) a systematic plan to build an emergency fund.
- Calculated and know your income tax bracket, because it will come up many times in later chapters.
- Started (or already accomplished) a mortgage buster plan.

"To the daring belongs the future." —Emma Goldman

CHAPTER 5

Building Your Portfolio

Okay, you've scaled back your debts. You now have, or are on your way to having, an emergency fund. And if you have a mortgage, you started a mortgage buster program. You're ready for the next step in your financial plan: building portfolios of equity investments in the stock market. The stock market, when used properly, is America's premier wealth builder, the number-one game in town. It is the core basis for high single-digit and double-digit returns. When coupled with the power of compounding, it is one of the keys to achieving and maintaining financial independence in the Age of Longevity.

The stock market has also been one of the greatest destroyers of accumulated wealth in America. From the crash of 1927 that triggered

the Great Depression to the crash of 1987 and the meltdown of 2000–2002, its capacity for making money vanish is legendary. The reason why so many people have lost money so often, in good times and bad, is because they have misused the market.

As a financial advisor, I have had people say such things as "I'm ready to *play* the market," or "Help me *gamble* in the stock market." That's how money is lost. If you want to gamble, I recommend Las Vegas. You'll lose money just as easily, but it will be more fun. If you want to speculate, fine; but you won't find help for that here. What I will give you is a systematic, commonsense system for never losing money in the stock market, for using the market the way it should be used—as an engine of wealth building, providing elevated returns.

THE DINAPOLI FAMILY: "I AIN'T EVER DOING THIS AGAIN"

When Tony DiNapoli came to see me in 2002 with his wife Regina, he had basically given up. No more of that "investing stuff" for Tony. He was going to stick to the bank and its 2 percent return, and that was that! He was only there because Regina dragged him in.

Tony worked in construction and belonged to one of the trade unions; Regina is a dental hygienist. Both earn good money. Their two kids are still at home, but they are in their 20s, working and self-sufficient. Neither of the kids went to college so Tony and Regina had large amounts of savings in addition to excess income. In 1994 Tony decided to invest because he heard all the stories from his friends and associates about all the opportunities in the market. Armed with three "solid tips," Tony put $60,000 in an account with Schwab. He bought just three stocks, two hot tips given to him by a fellow construction worker and a third recommended by a deli counter guy. He put about $20,000 each in PacificSummo, Checkers Restaurants, and a technical medical penny stock whose name I don't recall. The inside tip Tony got on PacificSummo was that the company had developed a new type of absorbent composed of bacterias that would literally eat jet fuel spills. The tip was that a large contract with the U.S. Air Force would soon be announced, and the stock would then go up tenfold or more. Checkers Restaurants was supposed to have a very depressed price given the fact that it was expanding from a local southern franchise to the large northern markets. The technical medical company was developing a device for diabetics that supposedly would be soon approved by the FDA, catapulting the price of the stock.

Within three years PacificSummo dropped over 90 percent in price, and it continued dropping until its value was below the trading commission cost. No only did the Air Force contract never materialize, but because the technology was flawed, no contract materialized. The technical medical company ran out of funds, never got the FDA approval, and went out of business leaving its stock worthless. Checkers Restaurant did okay in the northern states, but never made the big anticipated splash. The stock went down about 20 percent and stayed there. Tony's account was now worth about $15,000.

Regina stepped in and insisted that Tony call their nephew, Joseph, who worked as a stockbroker for Merrill Lynch. Joseph was a trusted relative, a nice young man who was beginning to be successful as a stockbroker. Tony closed out what was left of his Schwab account and in mid-1998, gave his nephew $50,000 to invest.

For 18 months everything went rather well. By the end of 1999, under the direction of their nephew, Tony and Regina's account topped off at $61,000. In another four or five years, Tony figured they would recoup their losses and step into the profit zone. After all, Tony wasn't getting any younger, and construction work wasn't getting any easier. One of the reasons they did so well was that their stockbroker had them heavily invested in tech stocks, internet dotcom companies, and other darlings of the brokerage industry. That seemed to be okay, even though Joseph mostly listened to directions from his manager who was barely three years older. After all, everybody was saying then that it's a different economy, the internet is here, technology is certainly here to stay, and you just can't lose by being aggressive. Tony and Regina's account seemed to bear this out, doing very nicely.

Then the great technical meltdown of 2000 rolled around, and Tony watched in disbelief as $60,000 turned into $36,000. He hung on because of encouragement from his nephew. Then 9/11 happened, and the account value dropped below $30,000. Tony closed the account. In seven years of stock market investing, Tony and Regina had lost $67,000 hard-earned dollars. Meanwhile my DABL (Diversification, asset allocation, buy, and long-term goals) portfolios had more than doubled during exactly the same period. DABL is a time-tested method of investing in the stock market and never losing money. I spoke to both Tony and Regina and explained our strategies and the DABL system, a methodology I will never deviate from. Two years later, after watching our results and gaining a better understanding of what true investing is, Regina is convinced, but Tony still refuses to invest. As he says: "I ain't ever doing this again"

Tony violated all four of the tenets of my DABL system. Not one, but all four! History teaches that you ignore these warnings at great peril to your money.

If you're reading this, Tony, maybe some day you'll change your mind. The fact of the matter is, you *must* invest in order to achieve financial independence and keep that independence in the face of inflation.

Tony and Regina's story illustrates the great problem with stock market investing. If you do it wrong, if you listen to the hype put out by some in the industry, you will rapidly lose money and be turned off to a very important piece of the financial independence puzzle.

BENJAMIN GRAHAM AND WARREN BUFFET

Someone who has never paid attention to investments and investment principles might think that Benjamin Graham invented those tasty crackers and that this book has Jimmy Buffet's first name wrong. But anyone who has ever read about or studied investing will recognize Warren Buffet's name and perhaps even Benjamin Graham's. It is from the work of those two investment gurus that I devised my DABL system for never losing money in the market. But don't think that I put together a magical whiz-bang system for making money, it's simply ancient wisdom (well, going back a few decades anyway) contained in the classic investment textbook *Security Analysis* (McGraw-Hill, 1951) by Benjamin Graham and David Dodd.

Warren Buffet has been called the most successful investor of our times, and it is obvious that many of his ideas, especially value investing and buy-and-hold, are influenced by those of Benjamin Graham. You see, there is a vast difference between investing long term for returns and just speculating. Speculation is like roulette, a game of chance with no investment science behind it. In the opening section of *The Theory of Common Stock Investing,* Mr. Graham states the following:

> *Even when the motive of purchase is speculative greed, human nature wants to conceal this unlovely impulse behind a screen of apparent logic and good sense.*

Isn't that what happened to Tony, hiding greed behind apparent logic that turned out to be flawed? Interestingly enough, Warren Buffet reflects Benjamin Graham's thinking in Buffet's 2000 Berkshire-Hathaway Annual Report in which he states:

> *Now speculation—in which the focus is not on what an asset will produce but rather on what the next fellow will pay for it—is not a game in which we will play.*

Neither will we, Mr. Buffet. Neither will we.

WHAT IS THE STOCK MARKET ANYWAY?

Sometimes it's easy to lose sight of the obvious; sometimes things get so complicated that their true meaning and origin is no longer apparent. So let's look at exactly what the stock market is—a marketplace where people can buy shares of American and foreign businesses. When you buy shares of a stock, you're buying a small percentage of a business. When you buy a share of a mutual fund, you're buying a slice of a fund that owns many small percentages of many businesses. You own a small slice of many businesses through that one mutual fund share. The stock market is actually a gathering of buyers and sellers at places like the American Exchange and the New York Stock Exchange. To better understand the pitfalls for investors, let's take a look at how a small business is bought.

Suppose you want to get into the hardware business, and there is a hardware store in your neighborhood that seems a good candidate for purchase. The owner agrees to sell, so now you call in someone for a valuation. (A valuation is simply a financial analysis of a business to determine its fair value for purchase.) Suppose the hardware store does $100,000 of business, the valuation might return as a multiple of earnings plus things such as inventory, goodwill, etc. Very often such a business will be sold by multiples of earnings, say in this case one and a half times earnings: $150,000. That would be reasonable. That may be a little high or low, depending on the exact circumstances, but somewhere around there would be reasonable. In buying a hardware store, there would not be much speculation or hype. After all, it's a hardware store, right?

Now let's suppose we take this hardware store, make it into a chain of 1,000 stores each earning $100,000 per year, call it Giganto Hardware Inc., and take it public on the stock market. Now we have Giganto Hardware Inc., a company that is being hyped as the next Home Depot, has earnings of $10 million annually, and is bound to make everyone who bought shares very rich. Ten million shares of Giganto hardware are issued, and the stock reaches a price of $18 per share. That is a Price/Earnings (PE) Ratio of 18.

The PE ratio is a measure of a stock's value in its most important fashion, how much it earns. The price is divided by the earnings per share to obtain the PE ratio. In this example, $10 million annual earnings are divided by 10 million shares for annual earnings per share of $1. The price of the stock is $18 per share, divided by annual earnings of $1, which equals a PE ratio of 18.

If you had applied that logic to the purchase of the individual hardware store earning $100,000 per year, you would have paid $1,800,000 for the store instead of $150,000. Insane isn't it? Yet during times of high speculation and bubbles, such as 1987 and 1999/2000, there were PE ratios of 160, 190, and higher. Filled with these overpriced issues, the market had only one way to go—down. It usually takes only one event, or one guru sounding an alarm, for people to realize they are sitting on overpriced assets and for them to head for the doors.

PE ratios will always be higher in the stock market than in the purchase of a small business. I used this example as an easy-to-follow illustration. In my real world investing recommendations later in this chapter, a key factor is value investing, keeping PE ratios of the investments I recommend at reasonable value.

That's the heart of the DABL system, a conservative value investing system with a catchy acronym to always remind you of the four principles of investing. Benjamin Graham reiterates this theme throughout his books, and in his classic 1932 book, *Security Analysis* (McGraw-Hill, 1934) sums it up very neatly:

> *Investors must practice unvarying insistence upon the reasonableness of the price paid for each purchase.*

Warren Buffet sums it up with this great quote:

> *Rule No. 1: Never lose money. Rule No. 2: Never forget rule No. 1.*

Thank you Mr. Graham, Mr. Dodd, and Mr. Buffett. Your ideas are what DABL is based on.

DON'T DABBLE: DABL, A SYSTEM FOR NEVER LOSING MONEY IN THE STOCK MARKETS

Each letter in the acronym DABL stands for a cornerstone investing principle that must never be violated, under penalty of losses: diversification, asset allocation, buy and hold quality, and long-term goals. Each will be explored in further detail.

D (Diversification)

One of the reasons Tony failed so miserably in his investments was a lack of diversification. He started out with just three stocks. When his nephew Joseph took over his portfolio, it never held more than a dozen or so stocks, and all of them were either technical or internet stocks. With just a few stocks in one or two industries, the risk is abnormally high. I want hundreds and thousands of stocks across large numbers of industries and sectors. Sure, my clients and I may want some technical stocks, but we also want manufacturers, pharmaceuticals, industrials, transportation, and on and on. In my portfolios, I use a number of mutual funds, bringing layer upon layer of diversification. It's the proverbial "don't put all your eggs in one basket."

A (Asset Allocation)

Asset allocation means simply allocating certain percentages of the investment portfolios toward sectors that have the potential to bring the best performance. In the July/August 1986 issue of *Financial Analysts Journal*, a study conducted by the firm of Brinson, Hood, and Beebower called "Determinants of Portfolio Performance," analyzed the variations in returns among 91 large pension portfolios. The study explained why one portfolio did very well and another terribly, why one made money while another one lost. The conclusion was that 93.6 percent of variations were due to asset allocation. In other words, the way portfolios were allocated proved to be the dominant factor in getting good returns.

Asset allocation is crucial. In my recommendations, I consider several factors, chief among which is valuations. I want to stay clear of sectors that are overvalued and/or overpriced. In mid-1999, my clients and I made a move away from the high-priced technology sector with all its dotcoms, internet issues, and aggressive growth, and moved into value funds, balanced funds, bond funds, and conservative growth and income. We did not escape the stock market drops of 2000 and 2001, but our losses were minimal, in the low single digits, as opposed to 30 to 60 percent for many investors who held individual nondiversified issues. They saw large portions of their holdings vaporize, never to return. By the end of 2003, my clients' allocations were ahead by over 18 percent for the years 2000–2003. Not a shining return, but not bad for the times. Other factors affecting asset allocation are: where we are in the economic cycle, where are interest rates heading, and what is the potential for various industries as opposed to their pricing.

Now a word about other asset allocations. There is a lot of confusing advice out there: Some of it is sound but easily misinterpreted, other is just nonsense. One particular gem from a popular financial magazine recommends that you allocate a percentage equal to your age to bonds. Another well-known financial firm uses a computer program that takes in certain questions and spits out an allocation based on the answers given. No consideration is given to anything except vague questions that investors often misinterpret.

You will find our current asset allocation and specific mutual fund recommendations to fulfill the allocation recommended later in this chapter. Check with our web site www.prosperousboomer.com for any changes in allocation and mutual funds. These recommendations are a moving, continuously examined model designed to average double digit returns over long periods of time, seven to ten years.

B (Buy and Hold Quality)

Now, I have to admit that I'm a little afraid to write this one. I think some stockbrokers out there may take out a contract on me. Although the stock brokerage industry is changing, and changing for the better, I truly believe it cannot continue with the same model it has had for the last 50 years. Here's the problem: Buy and hold always results in better performance for a variety of reasons, one being the trading costs. Brokerage houses are commission driven, all income is derived from brokers' commissions. Therefore, what are brokerage houses motivated to do? Buy and sell, and buy and sell, and rebuy and resell, and on and on. So, the interests of investors are in direct conflict with the commission structure of brokerages.

A 1993 Investment Company Institute survey on mutual fund redemptions showed that no-load investors were twice as likely as load investors to fully redeem their shares within two years. So how has all this buy-and-sell movement worked out for them? Here's the answer:

A Dalbar study conducted in 1994 and updated in 2000 showed that the average no-load equity fund investor who bought and sold funds realized annualized returns of only 5.32 percent compared with 16.29 percent for the S&P 500 during one of the greatest long-term bull markets ever recorded.

Benjamin Graham and Warren Buffet have always touted the superior returns of a buy-and-hold strategy and proved it with their own returns. One of the most comprehensive and impressive books on the subject, *Stocks for the Long Run* (McGraw-Hill, 1998) by Jeremy Siegel, also backs buy and hold with data analysis going from 1802 to 1992. We see more and more brokerage houses offering programs where the client is charged an annual percentage of funds invested. This method of compensation takes away the temptation for a broker to recommend excessive trading just to pump up commissions.

Buy-and-hold-quality means just that. I recommend a specific asset allocation along with specific mutual funds, and later a group of high-quality individual stocks directly from the companies in something called a DRP (Dividend Reinvestment Plan.) I hold them for long periods, a minimum six years with no maximum. Occasionally something may happen to that company or mutual fund that may cause me to recommend selling it. But that is not common, and it is always for good reasons that you are informed about through the web site.

L (Long-Term Goals)

Warren Buffet was once asked how long a good stock should be held. His reply—forever! That may be a little extreme. Our minimum long-term goal is six years, and unless special circumstances dictate otherwise, it's always longer than that. I have some clients who have held the same investments for more than two decades, and they are doing very well indeed. Now at this point, you might say something like: "Wait a minute. I'm 50 years old, and I'm retiring at 55. This can't possibly work because I will need the money before six years." That's where good planning comes in. Here's how it works.

This book gives you a retirement plan step by step, each step providing a foundation for the next one. In Chapter 6, I discuss how to assess your future income needs and how to construct multiple streams of income to handle those needs. A 50-year-old will not put all his/her assets in the stock market. There may be 40 or 50 percent, depending upon the results of your analysis through worksheets. Another 20 or 25 percent may go into varying instruments that guarantee income for a number of years, typically four to six or more. The remaining 25 or 30 percent may go into an opportunity fund, depending on what that person wants to do on reaching the target age. It buys the needed time for the investments to grow and to replace the income investments that will be spent down.

THE FIVE BASIC ACCOUNTS

There you have it, a basic system to manage stock market investments and never lose money. In the next chapters, you will work out formulas for how much you should invest and what percentage of income and/or current assets should be allocated among the different "life accounts."

There are five basic accounts you can build through the plan in this book. Some of you will use all of them, others just three or four. I'm not talking about your checking account or, if you're self-employed, your business account. These five accounts are targeted toward a special purpose, and when they are put together, they will give you financial freedom for life.

1. *Emergency fund.* There's no need to discuss that one further; it should be maintained through all financial seasons.
2. *Equity funds*. These are the stock market investments discussed in this chapter. They may take several forms, such as an employer's 401(k), IRAs, or variable annuities if appropriate (I will discuss those later), individually or jointly held with spouses or significant others. The percentage of earnings or existing cash to be invested will depend on factors I discuss in the next chapter.
3. *Future streams of income*. These accounts are designed to bring in streams of income, allowing time for other investments to grow. You may already have some of these accounts in the form of 401(k) pension plans, 403(b) etc. You factor them in and decide on a percentage to invest to build additional income streams.
4. *Real estate investments*. Along with the stock market, real estate has been a great builder of wealth in America. It also has the potential for disaster and requires a certain type of individual and a certain kind of thinking that I explore in Chapter 11.
5. *Opportunity fund*. So what tickles your fancy, what gets you excited and motivated, what is it you always wanted to do but have never really tried. As you approach financial independence and longevity, the time is perfect to enter the nonlinear life and head for your dreams. Sometimes, that takes a certain amount of money, a fund created for just that purpose.

Here are a couple of real life clients and friends who used such a fund:

- *John*. A house painter, he left Virginia and started a ministry to feed and house the hungry and the poor. His opportunity fund was the seed money that turned into a multimillion-dollar charitable enterprise.
- *William*. He left the Nassau County police force after 22 years and now runs fishing charters out of Montauk, Long Island. His opportunity fund provided most of the money needed for the boat and equipment, keeping financing to a minimum and insuring the success of his enterprise.
- *Kathy*. A single mom, struggled for years working in an insurance office, putting together her opportunity fund and going to college at night. She earned a master's degree and now operates her own successful family counseling practice. Her seed money came from the opportunity fund she diligently built over the years.

What John, William, and Kathy have in common is that they identified their dreams, believed they could make them come true, and took the steps to realize them by putting together an opportunity fund.

SPECIFIC RECOMMENDATIONS FOR ASSET ALLOCATION

In Chapter 7 you will look at building streams of income and go through a series of exercises to determine how much of current assets or income you should place in your equity-asset allocation. So, do not take action at this point on how diverse your investments will be. If you have funds that are already locked into a long time frame through various retirement plans, then it is appropriate to duplicate this asset allocation with the funds available in the retirement plan. If the plan is in an IRA, you can transfer funds through direct rollover to the exact funds recommended by following Figure 5.1.

Here is the contact information for the recommended funds.

Fidelity Investments	(800) 544-6565	www.fidelity.com
Vanguard Funds	(800) 662-2739	www.vanguard.com
Dodge & Cox Funds	(800) 621-3979	www.dodgecoxfunds.com
Clipper Funds	(800) 432-2504	www.clipperfund.com
Heartland Funds	(800) 432-7856	www.heartlandfunds.com

I have included the Dodge & Cox Funds even though they are not on my recommendation list. Their two top funds, the Dodge & Cox Stock Fund and the Dodge & Cox Balanced Funds are now closed to new investors. If you already own these great funds, you should continue to invest in them and replace the 20 percent balanced fund sector with equal amounts of those two great funds. I will keep you informed through my web site if these funds open again.

LARGE-CAP. Recommended fund: Fidelity Capital Appreciation	Growth	10%
LARGE-CAP. Recommended funds: Fidelity Contra Fund and Fidelity Dividend Growth, Vanguard Growth and Income (3.3% in each fund.)	Blend	10%
LARGE-CAP. Recommended funds: Fidelity Equity-income, Clipper Fund (One half of the 10% in each fund)	Value	10%
INTERNATIONAL LARGE-CAP. Recommended fund: Fidelity Diversified International	Blend	20%
MID-CAP. Recommended funds: Heartland Select Value, Fidelity Value Fund (7.5% in each fund)	Value	15%
SMALL-CAP. Recommended funds: Vanguard Small-Cap Value Index, Heartland Value Fund (7.5% in each fund)	Value	15%
BALANCED FUNDS Recommended funds: Fidelity Balanced Fund, Vanguard Wellesley Income Fund (10% in each fund)		20%

1. Large-, Mid-, or Small Cap. refers to the capitalization, or size of the individual stocks the fund buys: large stocks, midsize stocks, and small stocks.
2. Growth-, Blend-, or Value refers to the pricing, or value, of the stock. A growth stock would be higher priced relative to its actual value, with the elevated price reflecting the potential for growth. Value refers to exactly what the word means, the fund concentrates on buying stocks that are high quality, but have a lower price because of reasons other than its fundamentals. Blend means the fund buys both Growth and Value stocks. Balanced means the fund buys stocks, bonds, and preferred stocks, allocating them for best investment results in the current economic and market climate.
3. When there is more than one fund in one allocation, the money for that allocation should be divided equally among the recommended funds. Because these funds have minimum balance requirements, however, this may not be possible until your account reaches a certain size. Diversification on top of diversification. In my view, you just can't have enough diversification.

FIGURE 5.1 Asset Allocation

Action to Take Now

This is for people who have retirement funds that are locked in and cannot be used for at least six years, and want to manage them using the DABL system. Do not do anything yet with other funds or monthly investing. We will go through a series of exercises throughout the book that will determine the exact placement of those funds. What we want to do right now concerns only funds that we know are going to stay in those accounts for a good number of years no matter what. These include IRAs and self-directed retirement plans that you have control over, such as a Keogh Plan for the self-employed, SEP IRA, SIMPLE plan, any 401(k), or other retirement plans eligible for rollover.

Do not cash out of these plans. If you are deemed to have constructive receipt of the funds and do not roll them over within 60 days, the IRS will consider that a distribution and all funds will be taxed at ordinary income rates. If you are not over 59½ years old, it will be considered a premature distribution and a 10 percent penalty will apply. If you are in a high tax bracket, a mistake means you could lose 50 percent or more of your retirement portfolio through taxation. I have given you the toll-free numbers and web sites of the individual mutual fund companies. Contact them for direct custodial transfers. They will send you all necessary paperwork and help you fill it out.

The above funds have limitations as to how little can be invested. Most Fidelity and Vanguard funds will have $2,000 to $3,000 minimum for nonretirement accounts and $500 for retirement accounts. Check with the individual fund companies. Even if you have the amount for one or two funds, you may not have enough to fill the complete asset allocation model. If your account is below $500, consider making a contribution to bring it up to a total of $500. Then follow these guidelines: If you have $500 to $1,500, put your money in Fidelity Equity Income. Above $1,500, start with Vanguard Wellesley for its minimum required, then move on to Fidelity, as its minimum for retirement plans is $500. Go as far on the asset allocation as you can in proportionate amounts. If there is sufficient money in your accounts, adopt the asset allocation exactly as is.

Individual Recommended Funds

I chose the recommended fund families with several criteria in mind. Uppermost was good performance, consistency, and longevity. I wanted the funds to be among the top performers, year after year. Every one of the recommended funds are Four or Five Star as rated by Morningstar. Another factor was good service and low cost. If you have a favorite mutual fund, you may want to substitute for my recommendations, and that's okay. Determine what asset class it is (Large-Mid-Small Cap & Value-Blend-Growth) and substitute it for the fund I recommend.

There are over 10,000 mutual funds out today. It is impossible to figure out which one will be first next year, and in the final analysis, it doesn't matter. Chasing last year's winner is a fool's game that no investor can win. Steady consistent returns over long periods of time create wealth and unlock the door to your financial independence in the Age of Longevity.

Above all, I want this advice to be specific so a person can know exactly what to do at any given moment. It would serve no one to say go invest in mutual funds without specific recommendations.

In the next chapter, you will start with two crucial issues before continuing on to build your portfolio: The risk issues of the DABL system, and whether you should work with advisors. I will give you a common sense approach and a new way of looking at both issues.

Progressive Plan of Action

At this point, you have accomplished the following:

- Made certain you have completed (or begun) the earlier sections of the Progressive Plan of Action.
- Have started, (or already accomplished) a mortgage buster plan.
- Have a basic understanding of stock market investments and the DABL system for managing those investments.
- Transfered/invested your long-term retirement account using the current asset allocation and specific recommended mutual funds.

"I'm more interested in the return of my money than the return on my money."

—WILL ROGERS

CHAPTER 6

Setting Up Future Streams of Income

In investing circles, it is often said that "past performance is no guarantee of future performance." In fact, this statement is required by the SEC and the NASD for all prospectus and advertisements on stock market investments, as well as for companies and representatives that sell those investments. I don't disagree with that statement. It certainly prevents some abuses and properly cautions investors. However, it tends to fade in importance when applied to conservative, diversified investments. When dealing with risk, two areas must be properly defined:

1. Risk of permanently losing money in the short term—within one year.
2. Risk of permanently losing money within the minimum DABL time frame of six years.

It is absolutely true that past performance is no guarantee of future performance, but the past is all we have that we know to be true. In just about any endeavor, when results remain consistent time and again over any long stretch of time and effort, we may reasonably expect this to continue for the next equal time stretch. I stay in shape by running three to four miles per day. I don't know for sure each time I start out if I will complete the run. I have been running for many years, going back to the days when you wore something that was called a *sweat suit*, which you never wore anywhere except for sports. I guess that goes back 30 years, and so for 30 years, I have been completing those runs. There's no guarantee I will complete today's run, because past performance is no guarantee of future performance, but would you want to bet against me? If a driver routinely travels a high-speed stretch of desert road at 90 mph every day for a year in the same high performance car, past performance is no guarantee of future performance. Today the car may not be able to go past 60 mph. Perhaps it could, but what are the odds, and would you bet on them?

Past performance is no guarantee of future performance, but the past is all we have that we know to be true, it is our best, and only verifiable indicator. With that in mind, take a look at how one person fared using two of the mutual funds from my current asset allocation: Fidelity Equity Income and Dodge & Cox Balanced. Remember, the minimum investing time is six years.

RISK 1. Permanently losing money in any one-year period. That's a very real risk. If you invested for one year only during the last 20 years, you had a 30 percent chance of permanently losing money. Both funds lost value in 1987, 1990, 1994, 2000, 2001, and 2002. Now let me ask the crucial question, so what? My clients *never* invest for one year. My minimum is six years or longer, and most of the time well beyond six years.

So even though losing money in a one-year period is a very real risk, it is one clients never take when using the DABL system. So therefore, that risk is ruled out.

RISK 2. Permanently losing money during our DABL system minimum period of six years. It has never happened since these diversified mutual funds were created. Throughout wars, energy shortages, and numerous crises; it has never happened in over 65 years. So how likely is it to happen now? Take a look at the ten-year history of two of these funds, Dodge & Cox Balanced Fund and Fidelity Equity-Income, in Table 6.1.

But it wasn't just any ten-year period was it? In 1994, the funds lost value mainly because the Federal Reserve raised interest rates seven times, spooking the markets. During 2000, there was the great tech stock bloodbath, a veritable crash

TABLE 6.1 Ten-Year History

From January 1 of 1994 to December 31 of 2003

Fund	Returns Averaged per Year
Dodge & Cox Balanced	13.39%
Fidelity Equity-Income	10.67%

by itself. The following year, there was the treacherous 9/11 attack on America, shaking our confidence as never before. In 2002, wracked by worries over terrorism, Afghanistan, and Iraq, the markets tumbled once again. This decade saw a decline unprecedented since the Great Depression, four out of ten losing years, and still both funds managed to bring in annual double-digit averages.

Now if you look at the returns for each and every fund recommended, you will see that none have lost money in any six-year period. That's what the past tells us, and while it may not be a guarantee, it is certainly reassuring.

The lessons from history and from the returns of the funds in our allocations are that given time, quality nonspeculative issues, a buy-and-hold strategy, sensible asset allocation, and diversification, all the key elements of DABL, risk has been reduced to negligible proportions. Investment prices will fluctuate up and down for a wide variety of ever-changing reasons, but when they go down, they come back up in our time frame, and they go up in price far more often than they decline.

Now let's look at the real risk, the one that will snag countless Americans, especially the baby boomers. This is the risk from the story of One Hundred Average Americans. This is the risk that will have so many people handing out fliers at Wal-Mart, serving coffee and burgers, and performing other unwanted occupations simply because they need the money. It is the risk of complacency, of *not* investing, *not* planning, and *not* taking our destiny in hand, and hoping that circumstances, life, or the government will take care of us.

THE STORY OF THE THREE MINISTERS

Three ministers were fishing in a small boat and got embroiled in a theological argument. Two of the ministers argued that Jesus walked on water simply because he had great faith. The third minister argued that he walked on water because he was Jesus, the Son of God.

The argument raged back and forth until one of the ministers said to the third: "I will prove my point to you. I have been a minister for 20 years, and my faith is so great that I will walk on water." With those words, the minister stood, put one foot on the water, then the other, then took two steps on top of the water and stepped back on the boat.

The second minister stood and said to the third: "Now watch, it's my turn. I have been a minister for 25 years, and my faith is equally great." He then stood, put one foot on the surface of the water, then the other, and took three steps on top of the water before returning to the boat.

The third minister was astounded. Perhaps the other two were right, perhaps faith alone could allow him to walk on water. Suddenly he stood up and told the other two: "I have been a minister for over 30 years. I have more faith than both of you. It's my turn to walk on water." He put one foot on the water, then stepped out of the boat, and promptly sank beneath the water. He came up spluttering and spitting up water, got back in the boat, tried again, and once more sank beneath the surface. As the other two ministers helped him back into the boat, one said to the other, "Maybe we should tell him where the rocks are!"

And so readers, you're going to have faith. You're going to have faith in this great country, you're going to have faith in its systems, you're going to have faith in its government. Yes, you're going to have faith.

But you're also going to know where the rocks are, and if you can't find them, you're going to put them there yourself. With this book, you're going to set the financial rocks that will sustain you, and bring you freedom in the Age of Longevity.

Those in the know in government are also warning people. None other than the venerated Federal Reserve chairman Alan Greenspan, in a speech on August 27, 2004, (reported by L.I. Newsday, August 28, 2004) at an annual meeting of bankers and economists in Jackson Hole, Wyoming, stated that the country faces "abrupt and painful choices if Congress does not move quickly to trim Social Security and Medicare benefits." Mr. Greenspan went on to say: "We must recalibrate our public programs so that pending retirees have time to adjust through other channels." And what other channels would that be, Mr. Chairman? Obviously, he meant that pending retirees should start saving and investing more. The message is clear: take care of your financial future because no one else, especially the government, will do it for you.

The most worrisome risk is not the price fluctuations of the market or whether our investments gain or lose value in any given year, the real risk is to *fail to plan, fail to save, fail to cut debt, and fail to invest*.

GETTING HELP OR GOING IT ALONE

Before resuming the portfolio construction, one crucial area should be covered: should you get an advisor (or if you already have one, should you get a new one), should you invest by yourself, or should you use a combination?

Everywhere you look it seems there is that magazine, news article, or editorial expounding the merits of not having an advisor and doing it all yourself. Why pay a load on your mutual fund when you can go no-load and keep the fee for yourself? After all, how hard can it be? You just choose a mutual fund or two, find the cheapest insurance on the internet, and you're on your way. How hard can it be?

That philosophy can be applied to everything in life. Why not no-load roofing, plumbing, or auto repairs? How about no-load dentistry and medicine? How hard can all this stuff be? The internet and magazines will tell you all you need to know. For some people in certain areas, that will work out just fine. Do-it-yourself is a tried and true American tradition. However, consider the limitations.

Certain subjects have a magnitude of importance well above others. If you do-it-yourself for your automobile and make mistakes, you can always rent a car for a few days and have your mistake fixed by a professional. You can always shut down the main water valve for the house and wait for the plumber to correct your do-it-yourself plumbing error. In the final analysis, certain areas are not that crucial, and mistakes can be easily, if not cheaply, corrected.

Other areas are not so forgiving and will not give you a cheap second chance. In fact, you might not get a second chance at all. If you practice do-it-yourself medicine or electrical repair, an amateur mistake can lead you to the undertaker. In the financial arena, it can give you the illusion of success while ultimately leading you toward unrecoverable disaster.

It's important to differentiate between advice and information. Numerous financial publications generally supply information. That's fine if you know what to do with the information. I'm sure there are many terrific books on auto repair out there, but it doesn't make me capable of fixing my own car simply because I have the information. Taking information as advice is probably the biggest mistake financial do-it-yourselfers make.

Consider this "advice" over the years from *Money* magazine, a leading financial publication. These are taken from the actual cover headlines.

- February 1992: *20 Great Mutual Funds to Buy Now*
- February 1993: *The 12 Funds to Buy Now*

Only 1 of the 20 mutual funds from 1992 made it to this list a year later, so with the 12 new funds, that's 31 funds now recommended. Wait a minute, were you supposed to dump the other 19 a year later?

- February 1994: *The 9 Best Funds to Own Now*

None of the previous 31 recommended funds made it to this list. Do you now own 40 funds or have the previous recommended funds become no good? Have you lost money in the process? Probably.

- August 1994: The 10 Best Funds Today

What happened to the other 40? Does that mean the previous 40 funds, including the ones recommended just six months ago, are now no good or does it mean you should now own 50 funds? Obviously, owning 50 is impractical, so what do you do now?

How about in the area of life insurance? Let's look at *Money* magazine again. Here is a composite of "insurance advice" over the period from January 1987 to January 1993:

- 1987: "Under the new tax laws, traditional Whole Life Insurance is now the only product to buy."
- 1989: "The relatively new Universal Life Insurance policies have the flexibility that makes them the only product to buy now."
- 1990: "Variable Life Insurance policies have the flexibility and the potential for stock market returns that make this product the only life insurance you should have now."
- 1993: "Term life insurance is the only life insurance you will ever need."

Well, folks, that covers all the major life insurance policies. *Money* magazine does have one continuing thread in its insurance advice. It is extremely bad in its pushing of whatever policies the authors take a fancy to. A statement such as "this is the only policy you should have" is like saying penicillin or Prozac is the only medicine you should take. Buying life insurance properly is a result of a number of converging factors that include budget, needs, longevity, family situation, and a number of other parameters that are highly individualized. Life insurance is discussed in detail in Chapter 9.

I pick on *Money* magazine because it is the biggest. It is not a bad magazine to buy if you recognize it as what it is, a purveyor of financial information, not advice. Advice can only be properly given in the context of an individual situation, after appropriate analysis. It cannot be given wholesale, one-size-fits-all.

WHAT IT TAKES TO BE YOUR OWN ADVISOR

It takes three things to be a good financial advisor. Those three abilities and characteristics are crucial if you are going to be anyone's financial advisor, including and especially your own: training, temperament, and timing.

Training

Training is required because there are a number of important areas in constructing a complete and effective plan for financial independence, including:

- Budgeting/emergency/opportunity fund
- Risk management
- Retirement assets
- Equities planning and management
- Establishing future cash flow
- Real estate
- Education planning
- Tax planning
- Estate planning/long-term care planning/future generations planning
- LSE (lump sum events) planning

Many of these planning situations will apply at some point in your life. It depends on what financial season you are in.

You *can* be you own financial advisor if you want to. This book is your guide toward doing just that. I will tell you exactly what to do, the order in which to do it, and the way to do it, including additional publications or experts you may need to consult. For example, long-term care planning and estate planning are not priorities for a young person just starting out, and other issues may never be relevant. LSE (lump sum event) management, for example, concerns the tax and planning issues associated with receiving a large sum of money such as an inheritances or a 401(k) rollover from a job change.

As you move through your financial seasons, some areas will fade in importance while others become more important. A good financial advisor must be able to distinguish and prioritize which areas must receive immediate attention and when. A good financial advisor must be able to forecast necessities with distant time lines and create a program that will handle that future need.

Some areas, such as budgeting and emergency funds, are relatively simple with lots of help available if needed. Others, such as tax planning and estate planning, deal with complex and continually changing laws. Still other areas, such as equities planning and risk management, involve not only complex issues, but also carry an emotional burden. Fear, greed, and plain old wishful thinking are some of the biggest mistakes in the investment and insurance fields. An effective advisor must understand and manage all those areas. The advisor must not only have technical knowledge, but he or she must have the ability to address and manage emotional issues. That's sometimes very hard to do when your own finances and family affairs are involved. A person who is removed from the personal considerations can usually see more clearly.

Fidelity Investments commissioned the Dalbar research firm to determine how investors without advisors fared against investors with advisors for the decade ending in 1992. This was a good ten-year period in the markets, even with the crash of October 1987. During that time the indexes achieved double-digit average annual growth, with funds increasing from five to eight times their values. In that same period, investors without advisors using no-load funds averaged returns less then 1 percent per year while load-fund investors with advisors averaged double digit returns after fees were paid.

A 1993 Investment Company Institute survey on mutual fund redemptions showed that no-load investors were twice as likely as load investors to fully redeem their shares within two years. That's unfortunate because mutual fund investing should *always* be long-term.

Another Dalbar study conducted in 1994 and updated in 2000 showed that the average equity fund investor without an advisor realized annualized returns of only 5.32 percent compared with 16.29 percent for the S&P 500. This took place during one of the greatest long-term bull markets ever recorded.

Temperament

I am convinced, and numerous studies bear out my thinking, that the reasons the no-load investors failed to make money is because of emotional issues. Driven by anxiety-fueled reactions instead of the cold, calculated equation of long-term equity fund investing, they often crashed and burned their own portfolios.

They jumped in the market when it was near a peak. Driven by greed for quick, large returns and the emotional need "not to miss out on the gravy train," they purchased overly aggressive funds based on media hype and recent short-term performance. Examples of these situations are the merger and buyout frenzies of the 1980s, which led to market hype culminating in the crash of 1987. A more recent example was the technology and internet frenzy of 1998 and 1999. Scores of investors saw their recent purchases of funds plummet during the great technology shakeout of 2000. They sold out of fear and will probably sit on the sidelines as the markets inevitably go back up.

One of the key issues in reaching financial independence is to carefully manage funds and investment so as not to lose money on a long-term basis. A good financial advisor will anchor your investment program in sound goal-driven strategies that will protect your plan from the emotional storms that will surely come. Sometimes the best thing a financial advisor can do is to guide you toward doing nothing when nothing is the right thing to do. A good financial advisor will guide you toward investing and holding the appropriate funds and prevent you from being panicked out.

Timing

A good plan that will lead you to financial independence and long-term prosperity, the only kind of prosperity that will count in the coming Age of Longevity, will constantly change. It must change because the normal state of the universe is change. Change is the one and only constant, and it applies especially in the area of finance. Four things will always change:

1. Tax laws
2. The economy
3. The financial planning environment and its governing rules
4. You

Good planning toward financial independence requires constant management to adapt successfully to changes. For that, knowledge is needed, good technical knowledge of tax laws, the economy, and the like. Knowledge is only obtained at the expense of time. If you do not devote the amount of time needed to manage your plan, it will surely fail. If your advisor is too busy or neglectful and does not spend the time needed, your plan will fail. Consider my situation.

I am a good financial advisor. I work hard at it every day. To reach that stage, I hold degrees in accounting and economics. Each and every year I average 50 to 90 hours of continuing education. This is far beyond what is required to maintain my certifications as a Certified Financial Planner (CFP), Enrolled Agent (EA), and Registered Financial Consultant (RFC). I also spend endless hours reading articles, tax law opinions, as well as professional financial publications. Why do I spend this kind of time? Because that's what it takes to do my job effectively for clients. It's a complete, full-time job that takes all my working time.

Please don't get the idea that I am telling you that you cannot be your own financial advisor unless you quit everything and spend all your time planning. What I am saying is don't take it lightly. The advice in this book is very specific and will result in a sound financial plan with a minimum time commitment and no further training. However, you must still spend the time to read the book and follow its advice.

One of the mistakes that financial publications often make is to recommend doing it yourself to the exclusion of financial advisors. I don't believe that's appropriate. Not everyone will want to do this. If you would rather work with an advisor, that's okay. Either way, this book will help. You can match the advice and recommendations against the ones suggested by your advisors and check up on them. There are also a number of key strategies for wealth building and tax reductions contained in Prosperity Points that your advisor may not be aware of.

CHOOSING AN ADVISOR

Suppose you have decided that finding your way toward financial independence by yourself is not something you can do. You've decided you need help, that you must have what everyone in America is seeking: a trusted financial advisor. Where do you find one, and how do you choose him or her?

The first and most important issue to address is credentials. Suppose you didn't need a license or a medical degree to practice medicine. There probably would be a core of practitioners who would be very good even if they didn't have a medical degree, but how would you know? The wise course would be to stick with someone who went to medical school. Unfortunately, in the financial services industry, any person can just call himself or herself a financial planner and set up shop. The licenses (life insurance and securities Series 6 and Series 7) are not that difficult and require no education, experience, or training in financial planning. The licensing exams do not address the appropriate information to become a good financial advisor.

There are many good financial advisors out there that have no professional certifications, but how do you know? There are over 500,000 financial advisors who call themselves planners, but less than 10 percent have earned the CFP designation. Therefore, I must recommend that you hire advisors with professional credentials.

The most effective certifications to look for are dual certifications blending taxation with financial planning expertise. Unfortunately, this combination is rather rare, but it will be the most effective because it coordinates sophisticated tax strategies with financial planning.

In the tax area look for a(n):

- *Certified Public Accountant (CPA)*. The most well known certification. CPAs are regulated by the individual states.
- *Enrolled Agent (EA)*. EAs are regulated by the U.S. Treasury Department and can represent taxpayers before the IRS. They are generally considered tax experts.

Just because an advisor is a CPA or EA does not automatically mean that person is also an expert in financial planning. However, both these certifications require a high degree of expertise in taxation, accounting, and financial matters. In order to obtain these certifications, individuals must have achieved a high level of education and pass grueling examinations. They must also subscribe to a code of ethics, maintain high levels of continuing education, and will be subject to disciplinary actions by various government bodies and self-regulating organizations.

In the financial planning area look for a:

- *Certified Financial Planner (CFP)*. Within the last 15 years, the CFP designation has evolved into the most desired and coveted certification in financial planning. CFPs have a demonstrated understanding of the planning process and must undergo stringent standards of education, experience, and conduct, in addition to passing rigorous examinations. In my opinion, anyone serious about practicing financial planning should either be a CFP or a candidate working toward the designation.
- *Chartered Life Underwriter (CLU) or Chartered Financial Consultant (ChFC)*. A CLU concentrates in the field of life insurance whereas a ChFC tends to be more general. Neither designation reaches the level of expertise required of CFPs. However, both designations are acceptable credentials if a CFP is not available.

Because those are the top certifications in the financial field, they are difficult to earn, so they are the ones you should look for.

After credentials, here are other issues to examine in choosing an advisor:

- *Independence*. Be sure your prospective advisor is independent and not under the thumb of a sales organization dictating what plans must be pushed on a client. Since their deregulation, banks have been hungry for the investment dollars of their banking clients. Advisors working for banks often find themselves limited to products the banks are pushing. This may hold true to a lesser degree in the large brokerage houses and financial planning firms. I believe your best bet, if you can get it, is an independent financial planning firm beholden to no one except its clients.
- *Advisor expertise*. Chances are your prospective advisor was trained primarily in one of a handful of industries: banking, brokerages, accounting, or insurance. He or she will tend to be better in a primary areas of expertise. That's not to say the advisor won't have other areas of expertise, just be sure they are qualified to handle all your needs, especially if you have a problem or pressing need in one area.
- *Kinds of plans*. There are planners who don't plan, relying instead on generic software programs. Software-generated plans are easy to spot. Look for a multitude of color charts and graphs, and lots of boilerplate language that could fit any client by simply dropping in a name. Some big firms like American Express and Merrill Lynch use planning software. If you're going to pay for an advisor, you should get your money's worth. You want something tailored to your unique situation, and created from someone's experience and training, not by some one-size-fits all software.

- *Conservative mindset*. Stay away from the hot-shots with high-risk strategies. As Will Rogers once said, "I'm more interested in the return *of* my money, than the return *on* my money."
- *The advisor's record*. Most people spend more time figuring out what TV to buy than checking out a potential financial advisor. For brokers and planners who are Registered Investment Advisors and charge fees instead of commissions, check their form ADV online at www.adviserinfo.sec.gov. This form will contain information on your advisor's records. Such information includes records of sanctions, fines, and suspensions. For brokers, state securities administrators have more information. A quick online search at www.nasaa.org will bring up the web site for your state. The forms will contain information about educational experience, background, customer complaints, lawsuits, and violations. To check on a CPA, visit the AICPA, the self regulating body for CPAs at www.aicpa.org, and for EAs regulated by the U.S. Treasury Department, ask for the EA's number on his/her treasury card and check at www.ustrea.gov. Also check the professional organizations for your advisor's certifications: CFPs at www.cfp-board.org and CLUs and ChFCs at the American College in Pennsylvania at www.amercoll.edu.
- *Comfort level and accessibility*. How do you feel about this advisor? Are you comfortable talking with this individual? Do you understand what is being said or is the language loaded with jargon? How accessible will that person be if you have concerns? Be clear on that up front to avoid problems down the road.
- *Your responsibilities*. Responsibility is a two-way street. A good advisor will spend quite a lot of time getting to know your situation, your spending and saving habits, and your fears, hopes, and worries. Be open, and make the effort to provide complete information. Don't take your responsibilities lightly and forget appointments, dismiss recommendations out of hand without reason, or show a lack of respect for your advisor's efforts on your behalf.

When working with an advisor, understand that he or she will be paid, just like your doctor, pharmacist, plumber, or auto mechanic. If they do a good job for you, they deserve their pay just like you do when you work. Do not expect your advisor to recommend the no-load funds I recommend without charging you a fee or they may use equivalent load funds from which they collect a commission as payment. Either way, they will and should be paid. You should know how they will be paid. Ask. The answer will be one of three methods:

1. *Commission only*. The advisor will be paid only from the commission of products he or she sells. Sometimes that can be a problem when the only product needed does not pay a commission, such as money market accounts or legal instruments like wills and durable power of attorneys. Commission-only advisors tend to concentrate in particular areas, such as insurance and brokerage products like mutual funds, stocks, and bonds.
2. *Fee with commission offset*. This, I believe, is the most effective method of compensation for all parties. The advisor charges a fee, which is then offset by the commissions collected on any products needed. This way, the advisor's fee is assured without the need to sell any particular product.
3. *Fee only*. The advisor is paid strictly for advice and collects no commission. This is okay, but has a drawback. Most financial products pay commissions, so after paying a fee-only advisor for a recommendation, the client must go to another representative who will collect an undeserved commission, or to the company itself that will keep the commission or pay it to a favorite agent. In effect, the client pays twice. It is much better for the advisor who was paid the fee to provide the product. In this way, the advisor could be certain his recommendations are followed and he or she could apply the commission toward reducing the fee.

Members of the National Association of Personal Financial Advisors (NAPFA) pledge to be paid only by fees and to never collect a commission. They are good advisors with good track records. However, they contend that they are the only honest financial advisors around because they eschew all commissions and charge only fees. That's plain nonsense. That's another way of saying that advisors can only be trusted if the cookie jar is out of their reach. That's like saying a burglar in a particular building is now an honest person because the security in the building is so tight he can't burglarize. Nonsense.

The method of payment does not guarantee honesty or good advice. Any financial advisor has the potential to be dishonest or incompetent, like any lawyer, plumber, home improvement contractor, or auto mechanic. Honest advisors with training, experience, and credentials will always shine, and crooks will always be crooks. Your best protection is to check your advisor's background and record and be vigilant. They're all human, and a certain small percentage of humanity is dishonest and incompetent.

Progressive Plan of Action

At this point, you have accomplished the following:

- Made certain you have completed (or begun) the earlier sections of the Progressive Plan of Action.
- Understood the basics of investing risk, especially the risk of not doing anything to plan for your financial independence.
- Decided if you will do it yourself, following the commonsense advice in this book, or hire a financial advisor.

"The problem is never how to get new thoughts into your mind, but how to get the old ones out." —Dee Hock

CHAPTER 7

Creating Never-Ending Cash Flow

Sometimes having money is not enough. A person may have reached financial independence, but if the assets are not structured properly, that person may not reap the rewards. John's story is a perfect illustration of such a situation.

CASHING IN THE HOUSE: WHY A MILLIONAIRE HAS TO WORK

John is a millionaire and has been for a number of years. Yet he continues to drive a bakery truck past his 60th birthday. It's not that he has a thing about driving bakery trucks; it's that he needs the cash flow. His wife works

part time as a teacher's aide. It helps, but it isn't enough to provide the monthly income flow and close the occasional cash needs for the couple's real estate investments. So if he's worth over a million dollars, you might ask what good is it if he still drives a bakery truck? Exactly! You see, John made a classic retirement mistake. He didn't pay attention to the cash flow, and he didn't set up future streams of income that would have sustained him without having to work.

In 1979 at age 37, John bought his first house in Wading River, Long Island. It was relatively late in life for a first house. John had owned two businesses, and neither had done well. But he had managed to get rid of both of them without bankruptcy or being saddled with debt. He had also "invested" in the stock market in the same manner as the DiNapoli family in Chapter 5. He had the same predictable results, although fortunately for John, the amounts lost were much smaller.

Over the next six years, a spike in Long Island home prices doubled the value of John's house. John came to believe that real estate investment would be the key to financial freedom. In 1985, he refinanced his mortgage, taking out the maximum amount of cash possible. Between 1985 and 1987, he bought two houses and a condo, and saw them increase in value until 1988, when the Long Island real estate bubble burst and home prices dropped by about 20 percent. Prices remained there for about seven years. Rents also became tight as the local economy slowed from the ripples of the stock market crash of 1987. By 1996, things had picked up again, and through creative financing, John had managed to buy two more wrecks, handyman specials. John is about as handy as they come. As the millennium rolled around, real estate prices had surged again so that John's net worth by the end of 2003 was about $1.3 million.

So what's the problem? Why is John still driving that bakery truck?

Because you can't eat real estate. Equity doesn't pay bills; cash is required. John had never planned for income streams. When I first met him in 2003, he'd been driving that bakery truck about seven years too long. Rents kept up with the mortgages and occasionally showed a real profit. Then along would come a leaking roof, a deadbeat tenant requiring eviction, or any of the myriad of things that gobble up your profits. I know exactly how it works. I'm a real estate investor myself. Been there, done that, and have the T-shirt!

So John kept working, and it was a struggle. He drove the bakery truck days, and collected rents and handled problems nights and weekends. He was tired of it all, but was loath to cash in the houses. After all, how long would the money stretch?

"Pretty long if you do it right, John," I said. For the first time, John has done what he should have done seven years ago: he has sold two of the properties, set up income streams, and quit driving that damned truck. He's 60 after all! The trick was simply to have a plan for turning the capital gain long-term profits of real estate into steady, dependable income.

John is not alone in disregarding cash flow. Cash flow is what almost drowned Donald Trump on several occasions. Cash flow, setting up income streams, is a crucial component of your portfolio building. In this chapter, you will learn how to determine your need for income and how to set up the instruments that provide that income. You learn how to factor in income taxes. Of course, these needs differ greatly, so you will use worksheets to determine your specific income stream need and the best way to fulfill it.

Two examples from my files illustrate how cash flow needs can differ. Alan and his wife are in their mid-50s and are retiring this year. Both are teachers. The New York State Teachers' Retirement System will fill most of their income needs while they determine what they want to do the rest of their lives. Cash flow is not crucial for the moment. On the other hand, Thomas is also in his mid-50s. He is planning to sell his landscaping business and move to New Mexico. The modest funds from selling the business, plus Thomas's accumulated assets, must provide his income. There is no government pension for Thomas, so income planning is of the utmost importance.

INCOME STREAMS

There are three primary sources of income streams you can draw from:

1. *Preset income streams from other sources*. This is income that you are going to receive automatically, that you are entitled to but have no control over. Alan and his wife are an example. They are entitled to this income from their state teachers' retirement system. Once activated at retirement, they can't postpone, increase, or decrease it. Social Security benefits are another example, as are various other forms of retirement annuities. Other income streams could come from structured settlements from legal actions or annuity income from trusts and family foundations. Such income streams must be factored in your planning even though you cannot control them.
2. *Accumulated assets (non IRS qualified)*. The term "nonqualified" means that the income stream does not qualify by the IRS as retirement funds and does not fall under certain rules of transfers, required minimum distributions, and premature distributions or other rules governing IRAs and retirement plans. Savings, stocks, bonds, real estate, and any assets accumulated that are not tied up within an IRA, 401(k), or other retirement plans fall here. The trick now is to convert those assets into income.

3. *Qualified retirement assets*. These are your IRAs, 401(k)s, and other pension plans. The idea here is not just to convert those assets into an income stream, but to do it efficiently with the least tax liability possible.

Before you can determine the process to change assets into income, you first have to analyze your individual situation and answer four questions:

1. *When do you want the income to start?* Of course that has to do strictly with your individual plans and dreams, but usually it is the target date when you plan a zig or zag in your life. Maybe it's retirement at a certain date. Perhaps it is going into a venture that will bring more meaning and fun to your life but will leave a hole in your cash flow that requires filling in.
2. *How much monthly income is needed?* You just can't guestimate if you want to succeed. The exercises in Part III at the back of the book will walk you through a determination of this figure.
3. *How long do you want this monthly income to last?* Don't say forever! Nothing is forever. The economy will change, financial markets will change, tax laws will change, and above all *you* will change. Those changing needs and aspirations will always require adjustments in income. Inflation will assure that today's income will not meet tomorrow's needs. When you hear retired folks complaining that they're on a fixed income, it's because the purchasing power of their income, the only real measure of money, is diminished. The buying power of their income has not lasted. If you're targeting a gap in cash flow, perhaps you're starting a new venture that will produce income after a number of years. Then it's important to accurately gauge the amount of time you need this income. If you're dealing with retirement income, then you must factor in changes at various times to handle inflation and other factors in your life.
4. *What will replace the income when it is used up or becomes insufficient?* Right now throughout the United States, there are countless retirees enduring miserable retirements, working at menial jobs, or scrimping to get by simply because they never addressed that question.

You will work through these four questions later in the portfolio construction Chapters 8 through 14. Now take a look at the varying ways income streams can be set up.

One basic way to set up an income statement is by putting a bunch of money in a savings account and taking out monthly sums. That may work for a while, but it leaves a number of problems to deal with. In a time like the late 1990s and early millennium where savings account and CD yields are low, this tactic is a problem. There will be too much "lazy" money laying around, not growing and even losing ground to inflation. When I hear senior citizens complaining that they can't get by on their CD earnings, it's easy to see that this is no answer at all.

Every portfolio must have an element of growth. Remember, this is the Age of Longevity, and even if a person tells me they just want to live modestly, just get by in retirement, they still need growth. Consider that no matter how modest your chosen retirement lifestyle may be, for the average retiree, it's now lasting 25 years or more, and by the end of the decade, it will pass the 30-year mark. So ask yourself some questions:

- How much did a two-year-old, economy-model automobile cost in 1975, and how much does it cost now? How about an average midsize new car?
- How much did milk and a loaf of bread on sale cost in 1975, and how much can you get the same items for on sale now?
- How much did inexpensive jeans and a tee shirt cost in 1975, and how much does that same outfit cost now?

Get the idea? Every portfolio needs growth. You owe it to yourself and your family to prepare your financial affairs for a life of abundance and satisfaction.

METHODS OF INCOME STREAMS

There are a number of ways to derive income from assets, some of them very good, some not so good. The first thing you have to do is determine what you want from the income, that is to say, how important is this income? Is it meant to sustain you as a primary source, in which case it's of the utmost importance, or is it just extra play money? Or is it perhaps a little of both? It's time to look at the characteristics of some of the methods of driving income from your assets.

Dividends and Capital Gains

Dividends and capital gains are from preferred and common stocks and stock mutual funds. Under the new tax laws, qualified dividends, that is to say, dividends derived from stocks meeting certain criteria, receive favorable tax treatment with a top rate of 15 percent. That rate is a nice advantage for someone in a high tax bracket, and this method offers a nice stream of income if quality investments are used. Capital gains are sporadic. In good markets they will be fairly high, but are low or even negative in bad markets. When holding individual stocks, the shares must be sold to realize a capital gain, which is impractical as a source of steady income. One advantage of this method is that it allows the portfolio to grow in value with the market over long periods of time. Of course, the growth is diminished if dividends and capital gains are not reinvested, but reinvested gains and dividends provide a solid growth "kicker" for every portfolio.

The greatest disadvantage to this method is that cash flow is not steady and will fluctuate. This can be a real problem if you need a steady income stream set for a certain amount. Another problem is that the income is limited because the principal, the actual portfolio, is never touched, thereby capping the available income to what the portfolio can produce. Because of these inherent problems, this is not a method of income production I recommend.

Bonds and Bond Mutual Funds

Interest from bonds and bond mutual funds is a traditional way to gain income from a portfolio. Indeed, such portfolios are called "income portfolios." While widely used, this really isn't the best method of getting income. Retirees using this method in the 1990s were pretty happy until about 1994 when seven interest rate declines dropped the capital value of their bonds and bond mutual funds (yes, even U.S. government bonds) by about 20 percent. Still, those who had long-term bonds reasoned that if they just held them until maturity and used the income, all would be well, and it was until the time came to buy new bonds for income. During the second half of the 1990s, rates dropped dramatically and after 9/11, reached lows that had not seen since the early 1950s.

People who depended on this method for monthly or quarterly checks saw their incomes shrink alarmingly and, if they had no other sources of income, were forced to sell assets just to make ends meet. Not a very nice choice. Many people went to high-yield bond funds, unaware that "high-yield" is another word for junk bond funds. They exchanged a percentage or two of return for unacceptable levels of risk.

Bond traders use something called "laddering," which is simply setting up a portfolio of bonds with staggered maturity dates so income and principal is always available as time brings you up the ladder of bonds. This may be a great idea for bond traders, but it's not too efficient for people depending on a certain amount of income who find themselves at the mercy of prevailing interest rates.

Another shock occurs when interest rates go up, and people are left holding lower yielding bonds. The market price of the bonds is depressed, and they are faced with the unsavory choice of accepting a lower income or a capital loss from selling the bonds at the lower price. I do not recommend this method either because clearly there are better ways to set up income streams, as you will see later in this chapter.

Guaranteed Sources

Interest income from guaranteed sources such as CDs, money market accounts, and U.S. treasury notes is steady, but low. I find it difficult to call these products investments because investments imply a decent rate of return, which CDs and the like have not seen since the late 1970s/early 1980s. No one can get by on 2 or

3 percent, just ask any senior struggling with CDs. These instruments are strictly parking places for cash reserves, a place to put your emergency funds or money slated for a particular use in the near future.

Real Estate

Real estate rental income may be a good source if the properties are not leveraged, that is, they do not have mortgages or other debt obligations that will eat up the income. This is seldom the case. Most of the time real estate is purchased with a mortgage. Even when you have the cash available, I still recommend mortgaging to remove the equity and protect the property from lawsuits. (See Prosperity Point 5 on page 195.) In addition, income from tenants can disappear and even go negative when things like evictions are required.

There are several other methods, for example, limited partnerships, for income production, but I do not recommend them because of the level of risk, lack of control, and often lack of marketability. This area changes constantly with good ones and bad ones coming and going. The results, I feel, are not worth the risk. There are other more effective options for setting up future and present income streams.

BUCKETS OF MONEY

In order to find the best methods of generating income from investments, think about the problem a bit differently. After all, isn't thinking differently regarding what it's all about in becoming a retirement revolutionary? The first thing you want to do is think in term of goals and objectives and setting out specific amounts, "buckets" of money, targeted for specific objectives. Each bucket may be invested differently, depending on the time factors and other requirements of the objective. Of course, one of those objectives is setting up buckets to create streams of income, if not right away, then at certain points in the future.

The problem is that very often people think of all their assets in terms of a big bucket that will somehow (they hope) take care of their needs (see Figure 7.1). The trouble is, different needs have different time frames and objectives and require different investments.

As you go through the portfolio building exercises you're going to identify specific needs for each individual season of money. You will then construct buckets of money, with specific investments matched to each individual goal. Sometimes there will not be enough to achieve a particular need, but you will be able to identify the deficiency and set financial goals to fill this need. Your portfolio may then look something like Figure 7.2.

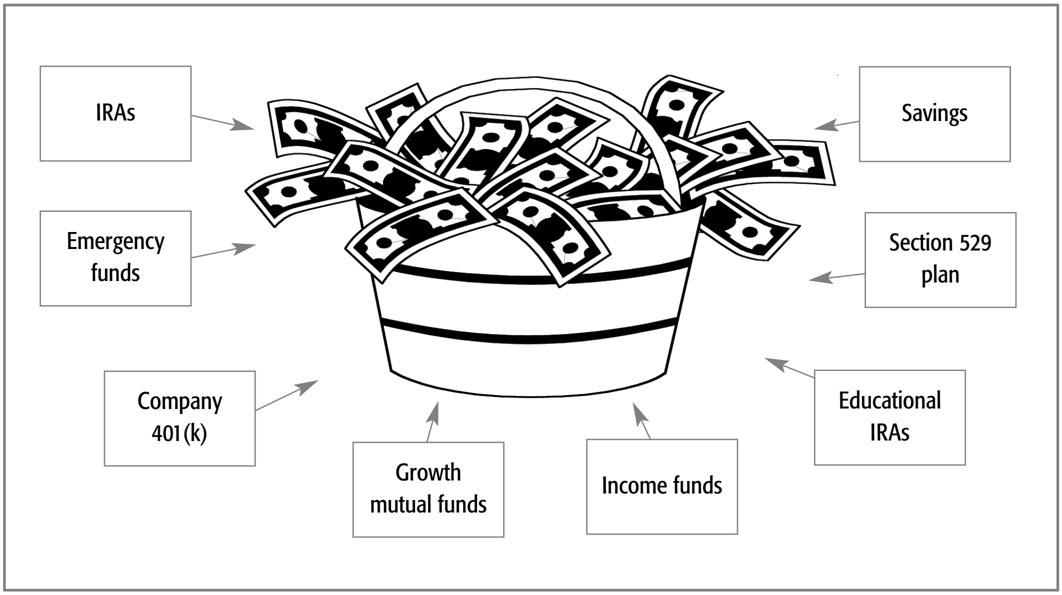


FIGURE 7.1 A Bucket of Money

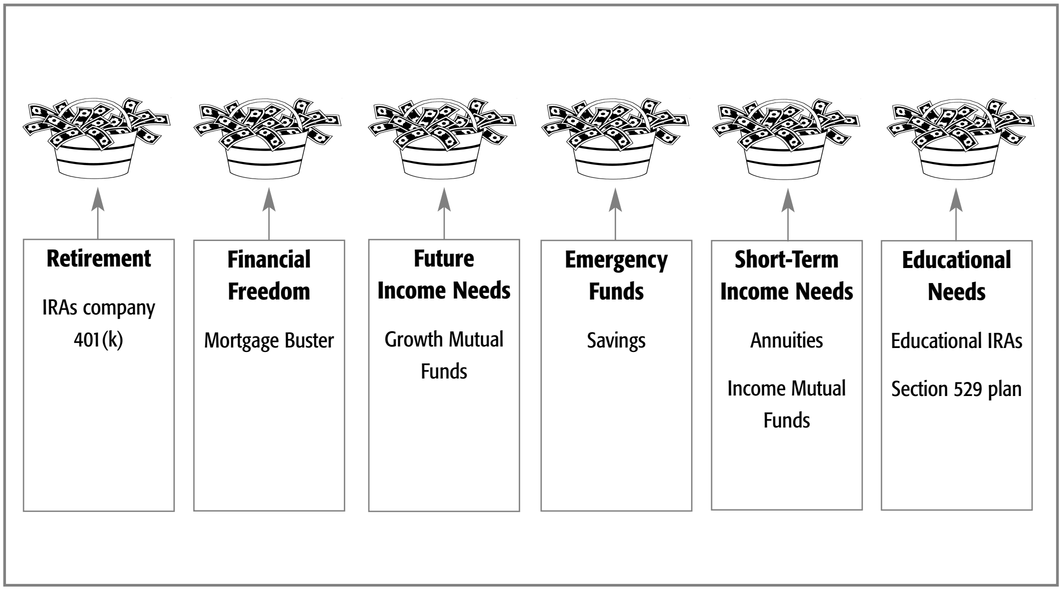


FIGURE 7.2 Buckets of Money

With this type of planning, you can correctly identify needs and quantify them for specific goals. You can determine exactly how much you need to put away and what kind of investments to use. But before you can start putting together your portfolios, you need to look at the best methods of putting together income instruments.

Desired Characteristics of Income Methods

The first thing I want to make clear is that I am talking about filling a serious income need. Whether income is needed for a year or two until a new business takes off or to fund a new lifestyle, the check must be there each month like clockwork for the amount needed. You can't call the electric company, the supermarket, or your mortgage company and say, "Hey, fellas, interest rates went down so I can only pay half of your bill. Okay?" Hardly! So the three characteristics you need are these:

LOCKED IN FOR A PRESET PERIOD OF TIME. First, you determine how long you need this income and that can vary widely according to individuals. Here are some examples from actual clients:

- A college professor retiring early at age 56 needed additional income to fill the gap until Social Security kicked in at age 62. For her, the preset period was six years.
- A couple opened an antique shop and needed three to four years worth of income until they got the shop running at full tilt.
- A 50-year-old Grumman engineer decided he wanted to live the nonlinear life. He retired from Grumman, started collecting his pension, and took on a much lower paying, but more rewarding job teaching at Basic Occupational Education (BOCES) in eastern Long Island. The couple adjusted their budget to the lower income, and it worked out just fine, except their daughter had just started college. We put together a four-year income plan to fill the gap.

Then we have the traditional retirement cash flow needs to supplement Social Security benefits. That sort of income plan must have an element to handle inflation. So even though the income plan is for life, it must be structured for periodic increases every three to five years. In all these cases, there is always that element of a preset period of time.

DEPENDABLE. The check must be guaranteed to arrive exactly as expected each month or each quarter, as you determine. There can be no delay or months skipped because a dividend didn't get paid or the capital value of an account went down.

GUARANTEED AMOUNT. Whatever the amount planned, it has to be there, in the correct amount. It cannot be less because interest rates or values fell this month or quarter. Your bills are guaranteed to be there, aren't they?

Now these three characteristics are plain old common sense, but it's amazing how many so called income plans fail to take in all three of these necessary traits into accounts. Now look at the income plans you will use to achieve your purposes.

GENERAL STRATEGY FOR LONG-TERM INCOME

There's no getting around the fact that if income is needed for a specific period of time and has to be guaranteed for a preset period of time, for dependability, and for amount, then a certain amount of money has to be committed to this plan. That's fine for relatively short periods, say one to five years. But what happens when income is needed for 6, 8, or 15 years, or perhaps for the rest of a person's life, which may be 30 or 40 years? Remember, this is the Age of Longevity. These days 30 to 40 years in retirement is showing up more and more, and perhaps may soon be the norm, not the exception. You don't want to lock in large amounts of money at low rates to ensure the income. You need to achieve growth in your portfolios, to tap into the long-term, double-digit returns of diversified equity portfolios. Here's how you do it.

You set up a number of buckets of money. You spend one down completely until it's empty. During that time, another bucket grows and replaces the money you've spent. That bucket will not be activated for income until the first is zero. A third bucket is allowed to grow for an even longer period of time until needed to replace the other two.

Take Roger Retirement-Revolutionary. He is 56 years old. He wants to retire early and become a beachcomber, which he estimates will bring in about $3 per week. But Roger RR has a company pension plan that will pay benefits immediately. When he can collect Social Security at age 65, he will have enough income to pursue his dream. His problem is that he will have 9 years with a gap of $1,100 per month to fill. Roger has saved about $95,000 but that doesn't seem enough to *guarantee* $1,100 income a month for nine years. After all, reasons Rogers RR (say that three times fast) that's $13,200 per year multiplied by nine years, which equals $118,800. At current CD rates, where Roger has his money now, his funds will run out somewhere between six and seven years. Figure 7.3 shows a typical income plan that will work for Roger.

In years one to three, Roger collects $1,100 monthly for the Utica National Immediate Annuity, which is a guaranteed income stream for three years. At the end of the three years, Roger's plan will look like Figure 7.4.

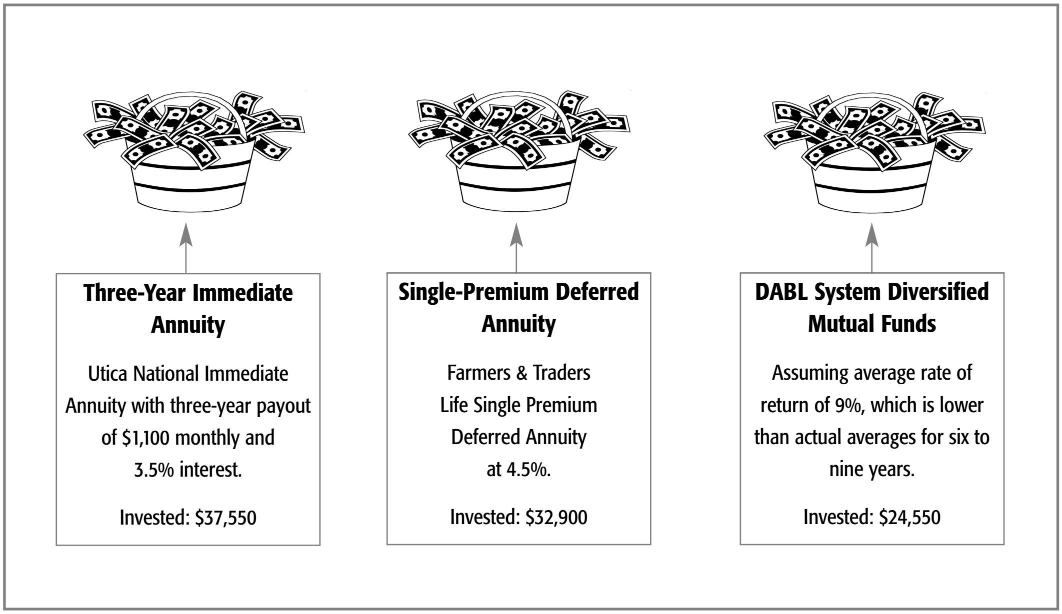


FIGURE 7.3 Roger's Nine-Year Income Plan with $95,000

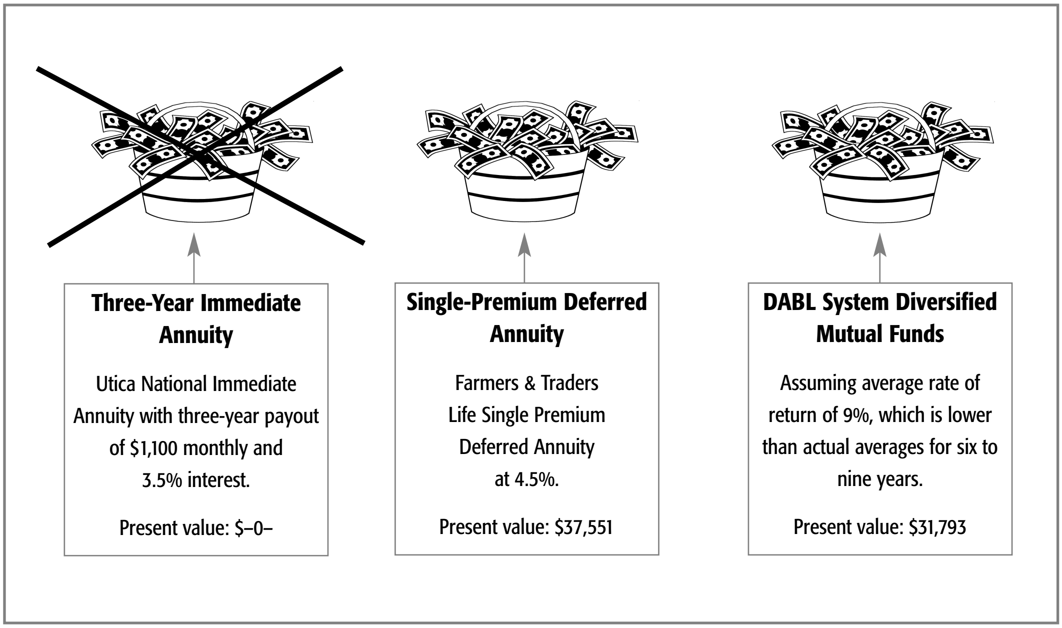


FIGURE 7.4 Roger's Income Plan after Three Years

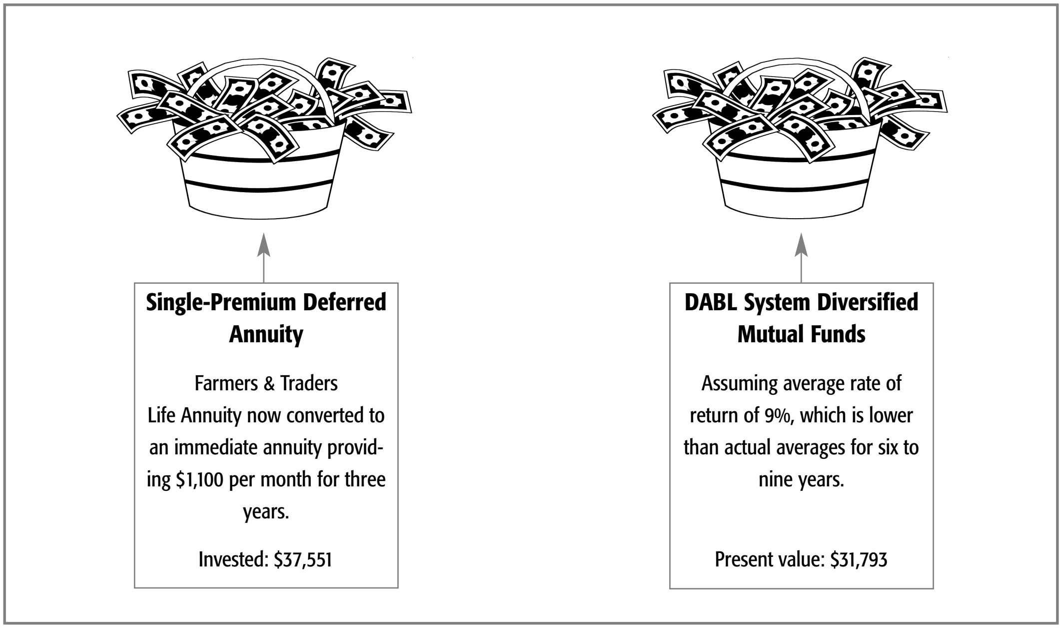


FIGURE 7.5 Roger's Income Plan for Years Four to Six

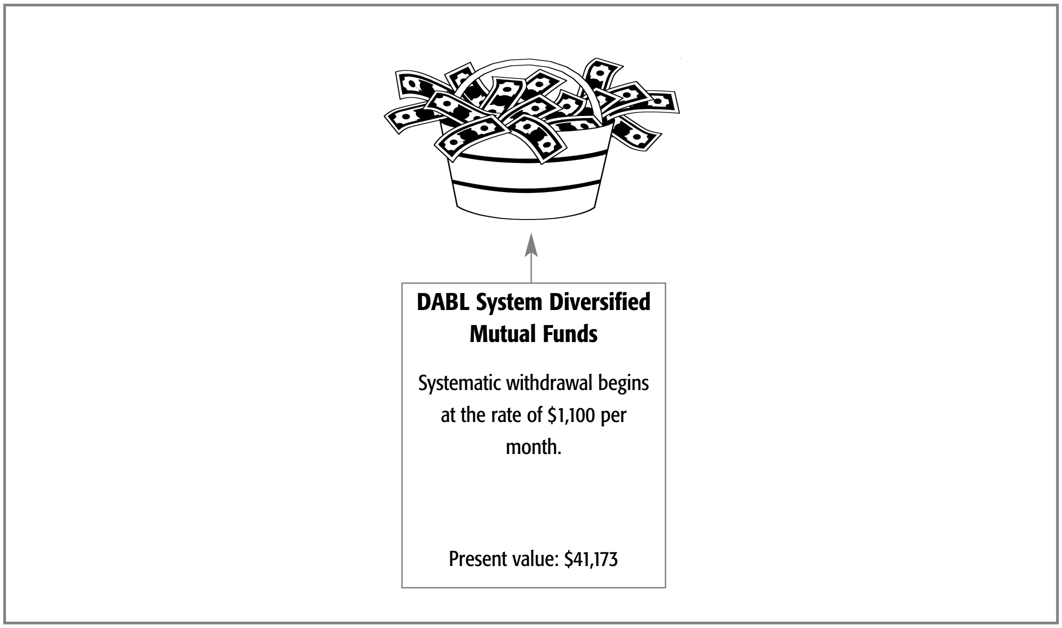


FIGURE 7.6 Roger's Income Plan for Years Seven to Nine

The first annuity from Utica National Life is now fully depleted. Meanwhile, the second annuity from Farmers & Traders Life has grown to $37,551. Roger now activates something called *annuitizing*, which is simply turning the current value of a lump sum into a guaranteed income stream for a chosen period of time. The period he has chosen is three years because that will give him his $1,100 per month guaranteed for three years. See Figure 7.5.

At the end of the sixth year, the Farmers & Traders Life annuity will be exhausted, and the diversified mutual funds will be the only bucket remaining. See Figure 7.6.

Now for the next three years, Roger begins *systematic withdrawal* from the portfolio of diversified mutual funds. By letting this bucket grow for six years, he has allowed it to reach a sum sufficient for his needs. The mutual fund companies are instructed each month to take a total amount of $1,100, first from dividends, then capital gains, and finally principal.

At the close of the last three years, the end of Roger's nine-year income plan is concluded. He has collected $1,100 monthly for nine years and has $9,424 left over. See Figure 7.7.

Three income methods were combined to assure a guaranteed income stream for Roger. If you take any nine-year period going back more than 30 years, Roger would actually have had *more* than $9,424 left over. The first two buckets are guaranteed, and there is no question that Roger would receive this income. The interest rates stated are average for the last five years. An actual plan would have to deal with interest rates available at the time and would vary somewhat, but the income is still guaranteed once the plan is activated. The unknown is the diversified mutual funds amount over the nine years. If this plan had taken place over

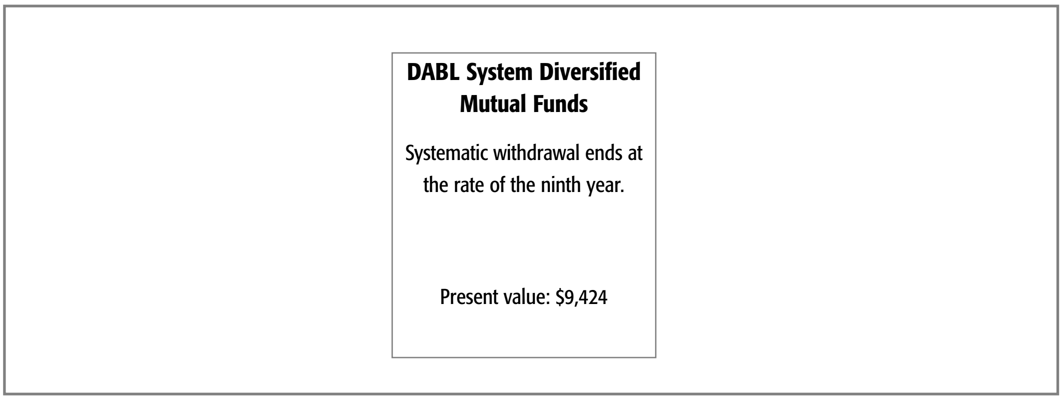


FIGURE 7.7 Roger's Income Plan after Nine Years

the last 30 years, there would have been more money than shown. Still, there is the possibility, no matter how slim, that the income could run out a few months before the end of the nine years. All in all, however, given the modest amount at the beginning and the income required for that length of time, this was the best plan with the least risk. In real life, I would have told Roger, "Most likely, this plan will get you through nine years with the income you require. However, I strongly recommend you find an additional source of moderate income, in case there is a shortfall before the nine years end."

This example also allows you to understand how income planning works. In real life, you also must deal with inflation that gnaws away continuously at the only real purpose of money, it's ability to buy goods and services. Perhaps I might even have recommended to Roger that he continue working for a year or two to build up his nest egg so he could be absolutely assured of increasing streams of income.

Basically, you are left with two methods of income that absolutely guarantee all three characteristics needed to ensure cash flow:

1. Annuities
2. Systematic withdrawals from conservative, diversified mutual funds

Both methods can be used effectively in combination, which may be considered a third method.

ANNUITIES

There are many varieties of annuities, but all have three elements

1. *The annuitant*. This is the person entitled to the income, the person whose age will be used when as the "life annuity" option is chosen. This element must be a human being; it cannot be an entity like a corporation or a trust.
2. *The owner*. This is the person who owns and controls the annuity. It could be a person or an entity such as a trust or corporation. Estate planning often creates trusts, which are funded by annuities. The trust may then provide a stream of income for trust beneficiaries. In business, a corporation may use annuities as a deferred-compensation device in which the company is the *owner* of the annuity and the *annuitant* is an employee who will be entitled to the income providing she or he remains with the company for a prestated number of years. If the employee leaves the firm to work for the competition, the annuity will be forfeited because the company owns it. This technique is also called "the golden handcuffs." An owner may also be the annuitant. This is usually the case when annuities are used to provide cash flow in retirement.

3. *The beneficiaries.* This is the person, or persons, who are entitled to the funds if the annuitant/owner dies. There are two sets of beneficiaries. The first is the *primary* beneficiary. This is the person entitled first. In the case of married couples, it is usually the spouse. It can be more than one person, in which case a percentage is assigned to each person. The second set of beneficiaries is called the *contingent* beneficiary. This is the person, or persons, who would receive the funds if the primary beneficiary dies before the annuitant. The classic case would be where the husband owns the annuity with the wife as primary beneficiary and their two children as contingent beneficiaries. If husband and wife were both to die in a car crash, the children would receive the amount as contingent beneficiaries because the primary beneficiary, the wife, also died.

Naming owners, annuitants, and beneficiaries is a vital part of setting up annuities for income. Annuities are also great estate-planning tools because all proceeds pass outside of probate immediately, without legal or other costs. As you continue with this book, you'll discover many more benefits of annuities, including tax benefits. However, at this point I must caution everyone. Annuities are complex instruments and should be part of a comprehensive planning process like the one in this book. Right now, many banks are doing a great disservice to their clients by selling annuities willy-nilly. Banks realize a larger profit here than when selling CDs. When interest rates drop and annuity rates are higher, many annuities are sold without planning, simply because they are a percentage point of interest higher.

Annuities are long-term financial products designed for specific income purposes and carry substantial penalties for short-term users. Please review very carefully the annuity warnings in Prosperity Points 6: Split-Funded Annuities (page 196).

Fixed Annuities

Annuities are "fixed" when the principal is guaranteed by the insurance companies and does not vary as variable annuities do. The interest is also guaranteed for a set period of time, usually one to five years, depending on the product and the company. Fixed annuities come in two basic types: single premium or flexible premium.

1. *Single premium*. A single premium annuity is one in which a single premium lump sum is deposited. After that initial deposit, no further deposits are accepted. This allows you to set up your buckets of money for future use.
2. *Flexible premium*. This annuity is one in which you make a series of deposits over time. This strategy lets you build up your buckets of money when you don't have a lump sum available. Many retirement plans such as the New York State Teachers' Retirement System, most trade union annuity retirement

plans, and many others, use flexible premium annuities to build up retirement plans assets for individual workers. A flexible premium annuity is the instrument you use in your mortgage buster (Prosperity Point 2).

Annuities can also be immediate or deferred. An immediate annuity is *Annuitized* and begins payments immediately. The period of time chosen can be as little as one, three, or five years. (Farmers & Traders Life Supplementary Contracts for one year is one of my favorites because of its great flexibility.) It can also be as long as 10 to 20 years. The income is preset and guaranteed for the period chosen, and depends on the amount deposited or accumulated. In an immediate annuity, the owner no longer has the right to the lump sum, instead the owner is guaranteed the income for the period chosen.

There is also an option called a "life annuity." Here the insurance company guarantees a certain amount of payment no matter how long or how little the person lives. I'm not a fan of this method because of its complete inflexibility, except under strict circumstances, and only after careful analysis. Once the life annuity is activated, it cannot be altered and will last the life of the owner with no possibility of change. Another version of the life annuity gives a "refund" of all amounts invested to heirs in the event of the owner's premature death. This is called a "period certain," that is, the person is guaranteed a number of payments to heirs in the case of premature death. The interest rates in this case will be lower than in the traditional life annuity. The best uses for a life annuity are when a person commits a certain amount to obtain a base income for the rest of his or her life, or when someone cannot be trusted to manage a lump sum amount for his or her entire life. The lump sum is converted into a monthly income stream. Life annuities are used in government pension plans in which the retirees choose from a number of options, all of which include income for the rest of their lives.

A *deferred* annuity is one that is not annuitized and is not yet producing income. The income is deferred, not used for the moment, in favor of letting the annuity grow larger with time.

Laddered Annuities

In this strategy, you set up a number of annuities to be activated for income at varying points in the future. While one annuity is providing immediate income, one or more are growing, to be activated when the first one runs out. This strategy is extremely effective in providing ever-increasing streams of cash flow. That's part of the strategy used in the Roger RR example with its two annuities. Particularly effective is using a split-funded strategy, setting up groups of two annuities to provide continuous and increasing income with numerous tax advantages. See Prosperity Point 6 for details.

Variable Annuities

A variable annuity retains all the features of fixed annuities, except there is no guaranteed interest rate or guaranteed rate of return. Instead, within the annuity is a basket of mutual funds called "sub-accounts." The idea is that in the long-term the mutual funds' sub-accounts will provide greater return than a fixed account at a modest interest rate. Because they are composed of mutual funds, variable annuities carry risk. They are also stock market investments and should be managed constantly and monitored like a DABL portfolio.

A series of tax law changes in the last few years have tarnished the value of variable annuities, yet they are still touted as a tax saving device. Much to their dismay, many investors have found by using a variable annuity they will actually pay more taxes eventually. Again, many banks and variable annuity salespersons have rendered a disservice to their clients by failing to plan properly and selling these instruments willy-nilly.

Variable annuities can still be a viable instrument for retirement and estate planning purposes, but now more then ever, care must be exercised. Variable annuities should only be used as part of a planning process after proper analysis.

Turn to Prosperity Point 3: The Lowdown on Variable Annuities (page 190) for answers on how and when to use variable annuities, and the tax issues involved.

MUTUAL FUNDS SYSTEMATIC WITHDRAWAL PLANS

I must point out immediately that this method fills only two of the three requirement needs. *Dependability* is just fine. Mutual fund families can be relied upon to make the withdrawals as required and send the checks on time. A preset dollar amount also works fine. The fund companies will withdraw the exact required amounts. The problem left is the amount of time the payments will last. The returns are not guaranteed, but vary with the markets.

A systematic withdrawal plan works by taking out the same dollar amount each month from a portfolio of mutual funds: first, from interest, then capital gains, and finally principal. You can only guess from historical returns what the earnings will be and, therefore, how long the money will last.

The best way to use this method is by investing a certain amount targeted for six or more years in the future. When the date arrives to draw cash from the portfolio, it will have grown to a value, allowing you to start withdrawing a monthly income. Care must be exercised that enough time is given for the investments to do their job. This component of an income plan should be overfunded so you have a reasonable chance of having excess funds.

This method is useful because it prevents lazy money, funds earning low interest for many years instead of tapping the power of diversified mutual funds for long-term growth.

It's time to review your Progressive Plan of Action and add your new knowledge of cash flow and setting up future income streams. Afterward, move on to Chapter 8 where you actually begin putting together your portfolio for each individual season of money you have reached.

Progressive Plan of Action

At this point, you have accomplished the following:

- Made certain you have completed (or begun) the earlier sections of the Progressive Plan of Action.
- Understood the basics of cash flow and the characteristics and methods needed to set up effective present or future streams of income.

"To profit from good advice requires more wisdom than to give it."

—John Churton Collins

CHAPTER 8

Portfolio Construction:

Putting It All Together

After reviewing the components and details of constructing a portfolio, you're now going to begin putting yours together in a systematic fashion that will be just right for your current financial stage, your season of money. After that, you will continue to build your portfolio, monitoring and increasing wealth until you reach financial independence.

THE FINANCIAL PYRAMID

Your assets and portfolio should be constructed like a pyramid, and for good reason. The pyramid has long been a symbol of stability and strength. With its wide base anchoring the structure firmly to earth, the pyramid can withstand the worst storm while protecting and sheltering those

within. You're going to build your pyramid equally strong so it can withstand any storms life may throw your way, sheltering and protecting your hard-earned financial independence. Eventually, your pyramid may look like Figure 8.1.

Start by identifying where you are so you can start building your pyramid. Go back to the exercise in Worksheet 2 (page 220), find your season of money and

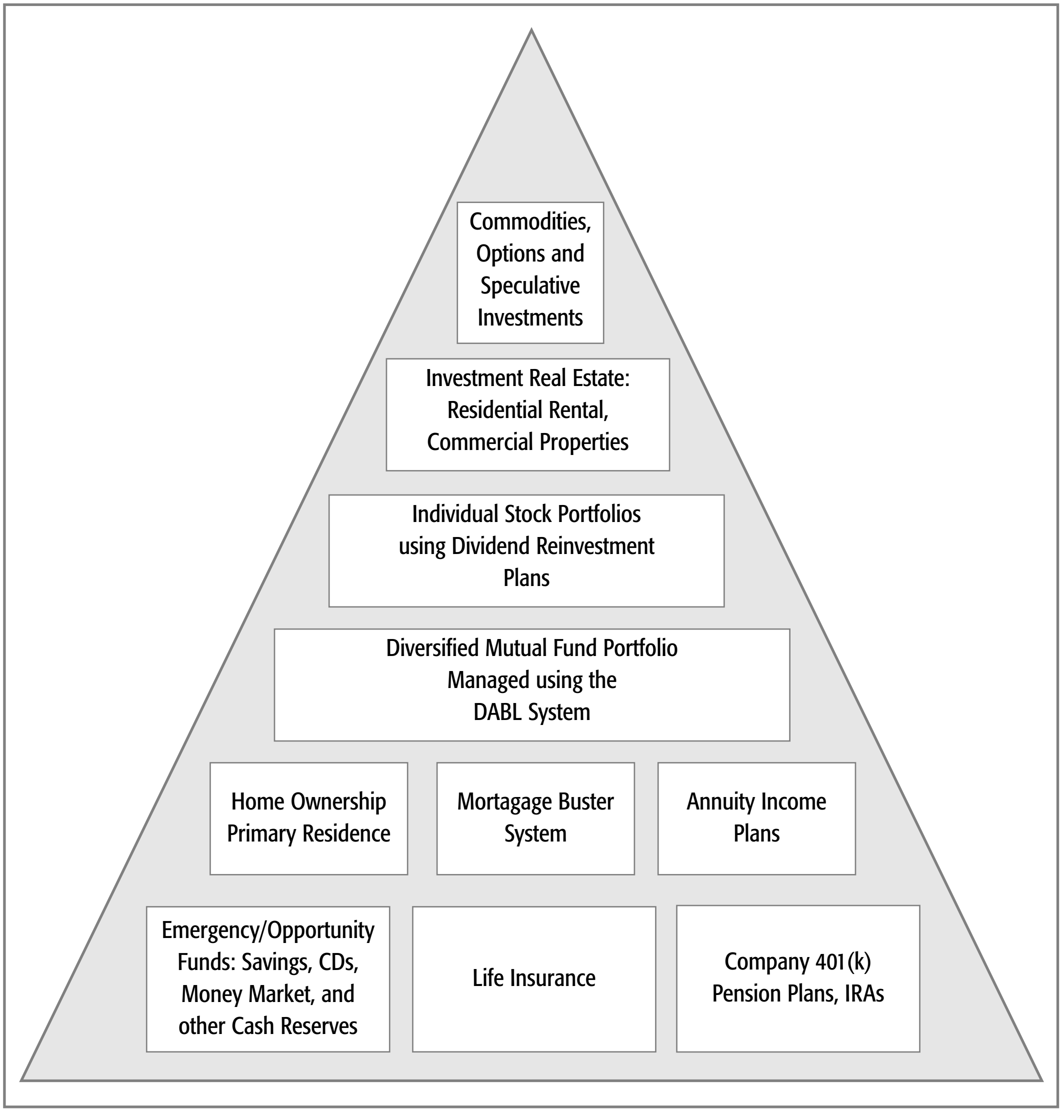


FIGURE 8.1 The Investment Pyramid

your asset percentage, then find your category from the five below, and finally go to portfolio building for your category later in this chapter.

Season	Accumulated Assets toward Financial Independence
Spring 1:	0 to 25%
Spring 2:	25 to 50%
Spring 3:	50 to 75%
Summer:	75 to 100%
Fall:	100% or more

DIFFERING CIRCUMSTANCES

Unfortunately, I can't meet with each and every one of you to cover the myriad of individual situations out there, no two exactly alike. The portfolio construction advice in these chapters gives you a solid guide that can easily be tailored to your particular situation. The goals and ultimate results, however, are the same for everyone: financial independence. From there, free of money worries, all doors will open for you and your family.

If you go to a construction site in any large city in America, or the world for that matter, you can tell how big the building will be by the size of the hole for the foundation. The bigger and stronger the foundation, the bigger and stronger the building. And so it is for our investment pyramid, the financial building that will sustain you in the many years you will enjoy in the Age of Longevity. It is in the first two layers of the pyramid where differing circumstances will dictate differing foundations. Two examples can show how two sets of clients and their differing circumstances resulted in different foundations for their investment pyramids.

Franklin

Franklin retired as a sergeant after 22 years in the NYPD. He's two years shy of 50, unsure what he wants to do with the rest of his life, and kind of bogged down as a caretaker for his elderly parents in New Hampshire.

Franklin was divorced about a decade ago. The couple never had children. After the divorce, he lived with a girlfriend for a couple of years until that broke up, and he assumed the life of a bachelor. Time passed. As Franklin approached his 22nd year with the NYPD, he didn't quite know what else he wanted to do, but he knew the time had come to leave the job. Meanwhile his parents had reached their mid-80s, and needed help getting through their twilight years. Neither could drive anymore, and home health care people, medications, and doctors' visits all had to be managed.

About a dozen years earlier, at my urging, Franklin had convinced his parents to purchase a long-term care policy, so the high cost of care was mostly covered by the policies. I had Franklin consult an elder care attorney in New Hampshire. (Elder care laws are regulated by the individual states.) The parents' house was placed in Franklin's name, and a new will was drawn up for the parents that would divide the balance of the assets between Franklin and his sister who lived in Tennessee. Franklin moved in and assumed responsibility for the care of his parents.

Franklin's investment pyramid is quite different from the one in Figure 8.1, especially in his two foundation layers. Having no heirs or needy relatives, Franklin doesn't need life insurance. He has a nice income from the NYPD retirement, so 401(k)s, pension plans, and IRAs are not needed or available. He has his parents' house and no mortgage. So home ownership and mortgage busters are not needed, and the same goes for annuity income plan.

Franklin has pretty much decided what he wants to do now. Because of the time constraints of taking care of his parents, Franklin will start part time as a security consultant. When his parents either pass away or reach the point where they can no longer be cared for at home, he will start his own security company. As a 22-year veteran of the NYPD, he is well qualified and enjoys the work.

The bulk of the work in Franklin's portfolio is simply to build an opportunity fund to provide start-up money for the security firm. Ideally, he may be able to save enough in his opportunity fund to avoid borrowing money for his start-up.

Peter and Marion

Peter and Marion present entirely different circumstances. They married young, have two children, and are planning a third. Peter works as a technician for a luxury auto dealership, and Marion works part time at home as a freelance paralegal for local attorneys. I met them a couple of years ago when they came to me for help in straightening out an IRS problem and then became financial planning clients.

They took to the 10 Percent Plus Solution like fish to water. Peter started doing side jobs repairing automobiles, and Marion enthusiastically tackled the family budget like a linebacker at the Superbowl. Their primary goal is to purchase a home as they systematically build the foundation of their investment pyramid. Peter has a 401(k) at work and contributes 3 percent, which is matched by his employer. He is not maxing it out yet, nor is Marion opening an IRA for her self-employment. Every penny is going for the down payment and other expenses on their home.

With a generous addition of $10,000 from Marion's parents, they have accumulated over $45,000. As I write this, they are deciding on which of three houses to buy. Their life insurance plan is set using a combination of policies for both of them (see Chapter 9). When they settle into their home and become comfortable with their new budget, they will begin a mortgage buster as well as an IRA for Marion and educational IRAs for the kids. They are following the traditional investment pyramid structure as part of a coordinated plan for financial independence. Peter is not sure if he wants to remain in the auto business, and Marion would like to start a full-time paralegal service when the kids are older and she can resume working outside the home. Peter and Marion are well on their way to a successful nonlinear life in the Age of Longevity.

FINANCIAL SEASONS

Everyone must tailor his or her plans and portfolio construction according to individual needs and wants. I will help you along the way with specific suggestions for each season. To break down your efforts more easily, Spring has been divided into Spring 1 (0 to 25 percent of assets needed), Spring 2 (25 to 50 percent), and Spring 3 (50 to 75 percent).

Spring 1

There's lots of work ahead in Spring 1. Roll up your sleeves, and get going. Spring is not the money season you want to be in. It's the struggling, accumulation years, still far away from financial independence. Your freedom is stifled by the need to work just to pay the bills. Although you're at the bottom of the bottom season, I want to tell you absolutely that you can get where you want to go simply by taking the advice here seriously, and acting on it.

Take a look at each building block on the foundation of the investment pyramid, especially the crucial bottom two rows. Examine each block, and see how far you've come up to now.

LIFE INSURANCE. You start with life insurance because if you have a need and have not gotten it, it's the most urgent thing to do. If you're single and have no one depending on you for support, or if your family has all the money they need without you, then you don't *need* life insurance. You may *want* it, but at this stage of your financial season, it's much more important to set up other areas of the foundation of the investment pyramid so you can move to growth and wealth building. If you have determined there is a need for life insurance, go to Chapter 9 and set up a program following the advice there. At this stage, there is so much to do, so many accounts to be constructed, that I recommend you only purchase term. You need to make every dollar count and so must put off completing a life insurance program with whole life until you make more progress.

EMERGENCY/OPPORTUNITY FUND. Be sure you have an emergency fund equal to about three months of income. See the previous chapters on portfolio building for specific recommendations on where to invest this fund. If you already have it, great! Maintain it, and only use it in emergencies.

HOME OWNERSHIP. I am a strong proponent of owning your own home. Much wealth has been created in the United States by people owning their own home. I have placed home ownership ahead of 401(k) and other retirement plans. Some people will disagree with me, and that's okay. But remember that my advice is based on real life observations and practice in the financial field going back to 1969.

As with every rule, there is an exception to this recommendation. If you have a company retirement plan, and the company funds it for you, terrific. You don't have to worry. Unfortunately, those plans are becoming very few and far in between in the private sector. Many 401(k), 403(b), and other retirement plans have a matching program, usually pegged at 3 or 6 percent. (By adopting matching programs, companies can avoid falling under onerous IRS regulations.) If that is your case, you *must* invest up to the matching amount. It would be sheer foolishness to give up this immediate doubling of your money.

If you do not have a house already, I recommend opening up an opportunity fund in addition to your emergency fund. This opportunity fund would be used for the down payment and other expenses of purchasing your own home. How much should go in this fund will vary greatly with the area of the country you live in and the local price of homes. Read the real estate section for some tips on home purchase.

There may be a reason why buying your own home is not right for you. You may be planning to move, you may have a job that requires moving a lot, you may be in a state of flux with your career, or perhaps you may have other satisfactory living arrangements with family (like Franklin). Those are all good reasons. Indeed, there are more unique reasons out there than I have room for in this book. One reason that is not valid is *fear*. You've got to live someplace, so why be at the mercy of a landlord and lose out on all the tax benefits and wealth-producing equity of home ownership. Find a good realtor, or do it on your own. But don't be afraid to take the plunge.

401(K)S, PENSION PLANS, AND IRAS. You've got your home, your life insurance, and your emergency fund. Now it's time to concentrate on retirement plans. Please read Chapter 10 on qualified retirement plans. Then put as much as you can into whatever is available at your workplace. Max it out if you can. If you do not have a pension plan at work, then open an IRA and fund it to the maximum allowed each year. If you are self-employed, review the retirement plan section, and choose the plan most appropriate for you. If you are fortunate enough to have an employer fund this for you, then immediately start a mortgage buster program (Prosperity Point 2).

It's important to note that if you have a pension plan at work and earn over a certain amount, the deductability of an IRA contribution may be phased out. The rules are complex and involve something called Modified Adjusted Gross Income (MAGI). The bottom line is you may not be able to deduct all or part of an IRA contribution. Check with your tax advisor for your situation. Many investment firms are recommending opening a non-deductible IRA anyway, touting tax-free growth. This doesn't add up under the new tax laws.

If you cannot fully deduct the IRA, don't invest in it. IRAs carry baggage: minimum distribution rules, 10 percent penalties for distributions under age 59½, gains taxed as ordinary income, and other pain-in-the-wallet rules. Why carry the baggage if you don't get the deduction? Under new tax laws, if you open a mutual fund portfolio that is not an IRA, most dividends are preferred and taxed at a maximum of 15 percent. If you hold them for over a year, you will only be taxed at 15 percent maximum capital gains rate. In addition, you have the freedom of using or not using the money, no matter how old or young you are. Nondeductible traditional IRAs simply do not make sense.

DEBT. Now it's time to examine *why* you are at Spring 1 with 25 percent or less of assets needed for financial independence. There may be a very good reason. You might be just starting out and beginning to build toward financial freedom, or you may have encountered one of the many curves life throws at us, such as business failures, divorces, or accidents. If that's the case, take heart. Remember that everything happens for a reason, and today really is the first day of the rest of your life. Believe in yourself and your family and that you can do it, and you will. Pick yourself up, and get going.

For many people, however, one of the reasons why they have not progressed enough financially is debt. Your portfolio and home may be worth $100,000, but if your credit cards, car loan, and equity credit line are up to $95,000, your net worth is only $5,000. Examine your situation. Go back to your worksheet. Look at what debt is doing to your net assets and how it's blocking your progress toward financial freedom.

Go back to Prosperity Point 1: How to Get Out of Debt in Five Years or Less (page 184), and immediately put a debt elimination plan in effect. Do this before you do the mortgage buster, before you invest in any annuity income plan, and before you take the next step of building a diversified mutual fund portfolio. Use the 10 Percent Plus Solution, and wring every penny out of it to get rid of the dragging anchor of debt. Keep at it until the only debt left is your home mortgage and perhaps a car lease/loan if it is unavoidable.

At this stage of a Spring 1 financial season, where 25 percent or less of assets to produce income have been accumulated, it is doubtful but not impossible that you will have reached the mortgage buster stage. If your emergency/opportunity fund, life insurance needs, home ownership, 401(k) and IRA needs have been met and debt is reduced to just a mortgage with perhaps some other low-level debt, you are ready for the next step. Begin using your 10 Percent Plus Solution funds to build a mortgage buster plan as outlined in Prosperity Point 2: The Mortgage Buster.

Spring 2

If you have reached this stage, you have accumulated about 25 to 50 percent of the assets you need to maintain your lifestyle, pay your bills, and generally provide the needed cash flow without working. You're one-quarter to half way there. So how do you reach the other side? How do you get 100 percent there?

The first step is to continue to apply the 10 Percent Plus Solution. Try to make it 15 percent, double it if you can! If you haven't started it yet, begin immediately. The 10 Percent Plus Solution is your key to financial independence. It's your first crucial step. Nothing will work financially as it should without that first step.

At this point in Spring 2, you should have the following:

- An *emergency fund* equal to three or four months income invested as previously described in the portfolio section. You may also have an *opportunity fund* for a bigger home or business venture. If you have no plans for such a change, be sure you do not put too much money in the parking places you use for emergency and opportunity funds. They are not investments and will not give you the returns you need to reach financial independence. They are just safe places to keep money for the short term.
- A *life insurance program* in place consisting of a large term policy and a smaller whole life policy for yourself and spouse as described in Chapter 9.
- You should be contributing steadily to a company *401(k), 403(b), SIMPLE Plan, SEP IRA, or other pension plan*. If you are self-employed, you should have these in place for yourself. If your company does not have a retirement plan, you should be contributing the maximum allowable to IRAs for you and your spouse. If you have children, you should be contributing to educational IRAs for each one of them. See Chapter 10 on IRAs and qualified plans for details.

- You should be a *home owner*. Owning your own home is a key part of the financial independence puzzle. If you don't own your own home for a good reason, like Franklin, that's okay. Move on to the next step. If you don't own a home because you didn't have the time, didn't feel like it, didn't think the market was "right," couldn't find the home you liked, or any of the excuses people make for themselves, now is the time to take that important step. In all my experience with people, I have yet to meet anyone who regretted having bought a home 10 or 15 years ago. In fact, most of what I hear on the subject is "Why didn't I do it sooner?"
- You should have begun, or been thinking about, some sort of mortgage paydown system. You may have started a bimonthly program, a systematic additional payment of principal, or maybe just throwing in a few bucks here and there toward principal. If you have, review Prosperity Point 2: The Mortgage Buster. Consider switching your strategy to this formalized system. Over the years, it is the best one I have found because it has tax advantages, safety, and flexibility. If you want to remain with the system you have, that's fine *as long as you have a working system to effectively reduce your mortgage*!
- You may have a mutual fund or stock portfolio. If you're doing well on your own, great! Keep going; review the previous portfolio building sections on the DABL system of managing mutual fund portfolios and the DRP system of owning individual stocks. (The DRP system is found in Chapter 10.) If you have not started building a portfolio, now is the time to begin. Split the 10 Percent Plus Solution evenly between a mortgage buster and accumulating a portfolio of mutual funds using the DABL system.

Spring 3

At this stage, with 50 to 75 percent of the assets needed to begin the life you want, you're about to round the corner to financial independence and stop having to work because you need the money. Read the paragraphs on Spring 2. You should have all well in place: emergency/opportunity funds, a life insurance program, funded retirement plans, home ownership, and a mortgage buster system. Now it is time to add three additional components from the investment pyramid. If you already have them, the task is to increase the amounts invested using the 10 Percent Plus Solution.

1. *Annuity income plans*. Even though they are part of the foundation of a well-constructed investment pyramid, in the first two-thirds of the financial "spring season" it is more important to build growth through a portfolio of mutual funds using the DABL system. But now, as you come closer to your

goal of financial independence, you must begin to think about setting up instruments that will provide guaranteed cash flow, income you can count on to replace the check you get every Friday for working in the salt mines! Read Prosperity Points 3 (page 190) and 6 (page 196), on split-funded annuity plans and variable annuities. If you have not begun accumulating money in such plans, it is time to begin.

2. *You should be on your way to having a well-funded diversified mutual fund portfolio using the DABL system.* Continue investing until it is funded to the recommended amount. How much is that? See Tips for All Seasons later in this chapter, especially Lifestyles and Income, and Allocating Funds from the 10 Percent Plus Solution.
3. *You may have reached the point where the next step is to build a diversified portfolio of individual quality stocks using dividend reinvestment plans.* This is one of the most efficient methods of building a diversified portfolio of quality, wealth-building stocks. It is the next stepping stone after building a respectable diversified mutual fund portfolio. The following chapters will give you everything you need to know to get started, build, and manage this part of your portfolio.

At this point, two questions always come up: Exactly when do I have enough in one account, such as the mutual funds in the DABL system, and when do I start a new account like the dividend reinvestment plans?

Read Tips for All Seasons at the end of this chapter. Those questions will be answered there because they apply to all, no matter what financial season you have reached.

Summer

You're doing well. Not only have you rounded the corner, but having accumulated 75 to 100 percent of the assets needed for financial independence, you're in the home stretch. The important thing to remember now is that more races have been lost in the home stretch than anywhere else. Don't be distracted and stumble. Stay the course, and I promise that by following the advice in this book, you will soon reach financial freedom and begin the nonlinear life of abundance you deserve. Here is what to do now:

- *Maintain an emergency fund* as described previously, and begin to do some serious thinking about what you will do with your life when you reach financial independence, the financial summer season where you have accumulated 100 percent of the assets needed for financial independence. You will be able to do what you always wanted to do, and that usually takes some wise financial planning. Perhaps your dream is opening an antique shop, an ice cream parlor, or a nonprofit organization for some good work you've always wanted to do. Whatever your dream is, it will probably take some special funding. Now is the time to analyze your dream projects, determine what kind of money will be needed, and begin an opportunity fund to make it happen.

- *Review your life insurance program*. Go through the steps outlined in Chapter 9 so your insurance program fits your improving financial situation. Maybe it's time to drop some of the term insurance because it's no longer needed, or perhaps you want to leave a greater legacy behind so another whole life policy needs to be added. Your situation may even be such that life insurance is not needed at all. I would urge caution on that last step because it's a "burn your bridges behind you" move. Restarting a life insurance program years later if you have made a mistake may not be possible because of health, and it absolutely will be much more expensive.
- *Continue funding your mortgage buster plan* if it has not reached the amount required to pay your mortgage. If it has reached the point where it can pay off your mortgage, don't activate it yet, but stop further funding. Instead, add that amount to your annuity income plans so when you reach financial independence, the mortgage buster pays your mortgage, and your annuity income plan provides cash flow. The combined result is financial freedom.
- *Be sure your investment pyramid* is in a state of balance and not skewed toward one group of investments to the detriment of the rest of the building blocks. Read carefully The Skewed Pyramid Tips for All Seasons at the end of this chapter.
- *Consider investing in real estate*. Read Chapter 11 about investing in real estate, and decide if it is something you want to do. *This is not for everyone!* I want to make it clear that if you are nervous or uncomfortable with real estate investments, don't do it. It is not a crucial step. There are millions of people who have reached financial independence and a comfortable retirement without any real estate investments except the home where they live. If, however, you are comfortable with real estate investing, you may find such investments shorten the path toward financial independence, as it has for many. Read Chapter 11, Real Estate, to determine if it is for you. If the answer is yes, you're in the perfect financial season to get started.

Fall

Congratulations, you have arrived! The worksheet exercise indicates that you have approximately 100 percent or more of the assets needed to be financially independent, to quit working if that's what you want, and to do only what you want. The trick now is to set things up so you can enjoy the nonlinear life and your longevity. Just because you have the assets doesn't mean you're ready. The story of John in Chapter 7 illustrated this very well. John was a millionaire who had to keep driving a bakery truck because his assets were skewed toward real estate and the cash flow was missing. It is amazing to me how many people skip such an important fact and fail to address the question that follows:

Fact:	Bills must be paid.
Question:	Where will the cash come from to pay the bills?

I don't care how many assets you have, if you don't have the answer to the above question, you are not financially independent. That doesn't mean you can't be. It means you have to restructure your assets to provide cash flow. It's simple in concept, but not always simple to put in practice. The message I want to get across is that you can have all the assets you need, but if they are not structured to provide financial freedom, what good are they?

- *Income to assure a good cash flow*, and perhaps an opportunity fund for the realizations of our dreams, is the most crucial item to set up now.
- *Risk management and estate planning* are equally important and right up there with cash flow. The saddest thing in the world is to struggle and persevere, to finally achieve the dream of financial independence, only to watch it crash because some crucial part of an insurance program or some other risk management device was missing. Review Chapter 12 on risk management and Chapter 13 on estate planning because those should be among your priorities.
- *Managing your portfolios* is also critical at this point. There must be growth with the lowest possible risk. The DABL system of managing mutual fund portfolios is ideal for achieving growth while maintaining safety. You should also have a complete set of individual stocks using dividend reinvestment plans, which are described in Chapter 10.
- *Investment real estate* may be part of your portfolio. Review Chapter 11 on real estate investment, and determine if it's something you want to do. Pay special attention to the risks outlined and the cash flow section. The biggest risk in this financial season is the loss of cash flow necessary to maintain your financial independence due to real estate cash needs.
- *Debt* should be gone by now. The mortgage buster should be activated and paying your mortgage. If you have any other debt outside of real estate, get rid of it. Sell mutual funds or stocks if you have to.

TIPS FOR ALL SEASONS

One of the problems often encountered on the road to financial independence is that instead of steadily and systematically building assets and instruments to provide a good foundation, cash flow, and safety, entire sections of investments are missing. I have seen people without life insurance or retirement plans suddenly cash in entire mutual fund portfolios and buy real estate. That is often true after a bad year in the markets. Instead of waiting for the markets to rise as they always do, some investors sell at a loss and jump into real estate or some other investment, not fully realizing the risk or the length of time required for the new investment to come to fruition.

An investment pyramid like the one in Figure 8.2. It is not a pyramid at all. It's a group of investments chosen according to the belief of the moment, randomly thrown together instead of being carefully constructed from the foundation up. A good wind can bring it crashing down, and life often throws us ill winds in the form of bad tenants, bad investments, illness, unemployment, accidents, and other tragedies, even death.

Think of your financial independence in terms of construction, because in a way it is. You are building a financial house for you and your family, and it must

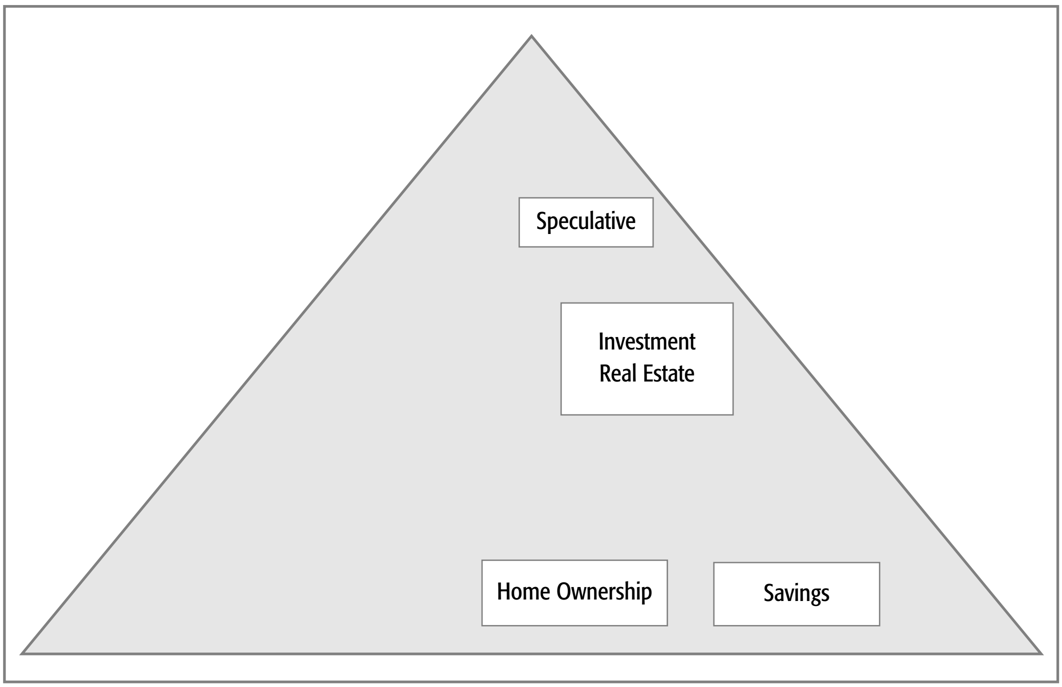


FIGURE 8.2 A Skewed Pyramid

last a lifetime. How do you build a house? Does a carpenter come along and maybe put up a wall or two, then someone else drops by who is an expert in roofs and builds a neat looking roof, all this thrown together haphazardly by whomever prefers a certain part of the construction process? Hardly! A good, sturdy house is built systematically. First, plans are drawn up, a foundation is poured, a floor goes over the foundation, followed by walls, topped by a ceiling, and then the roof is put in place. Your financial independence should be built like that. You start with the plan in this book and systematically put it together starting with the foundation, building up until you reach the roof.

Take an 8½-by-11 sheet of paper, and draw an empty pyramid. Now place your investments like the ones in the investment pyramid in Figure 8.1. How does it look? Are there a lot of gaps? Even if you are quite lucky, life just gives you roses, and you reach a point where the value of your assets provides financial independence, it may not happen simply because your investments are skewed in one area and cannot provide needed income.

Now go back to Worksheet 2 on page 220, and go to the end of Step 4: Total Retirement Income Needed. This is what your assets must provide. Your real estate or other holdings could be worth all the money you need to get this income, but it must now be converted to the instruments that will provide it. Read Chapter 7 again on how to set up income streams and Prosperity Point 6: Split-Funded Annuities. You will want to reorganize your assets and sell an appropriate amount to put together an income plan to meet your needs.

Starting a Mutual Fund Portfolio Using the DABL System

If you are in Spring 1, 2, or 3 and have not yet started a mutual fund portfolio, here's how to do it. If you have a lump sum, maybe some excess lazy money sitting around getting 1 or 2 percent in a savings account or you sold some assets to equalize your investment pyramid, it's fairly simple. Go to Chapter 6, contact the recommended fund families, obtain applications, and invest the recommended allocation percentages in the specific funds. To have a completely diversified portfolio following my asset allocation will require a minimum of about $35,000. But what happens if you don't have that amount, what if you have $5,000 or maybe just $100 per month? Follow the instructions below.

Begin with one allocation at a time starting with the bottom one, balanced funds. Currently, as of January 2005, I recommend a 20 percent allocation into the balanced funds named in Chapter 6. Be sure to visit the web site www.prosperousboomer.com for the latest allocation and fund recommendations.

Call the funds, and find out their minimum investment. If you do not have that amount, then begin a money market account with that fund family—they usually have a much lower minimum for money market accounts—and then add to the account until you reach the minimum. When you reach their minimum, you will be able to transfer the money into the mutual fund with a phone call. Set a goal of total dollars invested. In this case, suppose your goal is $35,000. Keep investing in the balanced funds until the account reaches the recommended allocation of 20 percent. In this case 20 percent of your goal of $35,000 is $7,000. Once you have reached that goal, repeat the process with the next allocation, small-cap value. Do the same thing with the recommended funds on this allocation until you have reached the recommended allocation of 15 percent. In the example, 15 percent of $35,000 is $5,250. You now have reached 35 percent of your goal. Go on to the next allocation, and keep going until you have a completed portfolio of the recommended mutual funds in the correct allocation.

Don't forget to rebalance the portfolio to the current recommended allocations. You may have to do this even as you build your portfolios. For example, if you have built the balanced funds and the small-cap value allocations, and are working on building up the mid-cap value allocation, you may find that during that process, the balanced funds portfolio had a nice run-up and now comprises 30 percent of the portfolio. Sell enough shares to bring it down to 20 percent again, and invest the proceeds in the next allocation. This will keep the portfolio in a healthy diversified balance while taking profits.

Lifestyles and Income

At the beginning of this chapter, I asked why, if you are in Spring 1, do you have only 25 percent or less of the assets needed toward retirement/financial independence. Why so little, and how can you move this along faster? There are a number of answers that are acceptable or, if not acceptable, at least beyond your control for the moment. You may be young, just starting out, or have suffered a setback such as a business failure, accident, or illness. Perhaps you just didn't pay attention, spent money like there's no tomorrow, and got yourself in a financial jam.

If it's a situation like these, don't worry about it. The past can never be changed. The important thing is to pick yourself up, learn the lesson, set goals, and armed with the advice in this book, begin your journey toward financial independence. Never get discouraged. Never give up. You have more capabilities than you can dream of. I am the eternal optimist. If somebody left a ton of horse manure at my doorstep, I would be happy because I know there's a pony around somewhere and all I have to do is find it! Whoever you are, dear reader, I know with certainty that you can rise above the problems and achieve your goals!

But what if you've had no such problems? What if you're a baby boomer discovering late in life that even though you may be entering the fall of your physical years, financially you're still in the spring season of money, having accumulated less than 25 percent of what you need to retire yet approaching retirement age at warp speed?

It's probably time to examine your lifestyle. This is a crucial reckoning that must be dealt with if you don't want to be flipping burgers when you're 70. Also remember that we are entering a longevity revolution, so unless you heed this financial wake-up call, the need-to-work era may stretch to decades.

Here's the good news: You can change things; you're not stuck. Read the beginning chapters again, paying special attention to Chapter 1's Three Steps to Financial Freedom, Chapter 2's Ideas to Paradigms, and Chapter 3's Money Awareness, the 10 Percent Plus Solution, and the Millionaire Next Door. Then roll your sleeves up and get going, because with the advice in this book a prosperous retirement awaits you in the Age of Longevity.

Allocating Funds from the 10 Percent Plus Solution

Suppose you diligently applied the principles of the 10 Percent Plus Solution in this book and now you have some discretionary funds, money left over at the end of the month to fulfill your goals. How do you allocate it? Do you go for one goal at a time, or maybe try to fill a couple of accounts at the same time? Here is what to do:

1. *Set up your emergency fund*. That's always your top priority.
2. *Determine your need for life insurance* (see Chapter 9). Apply whatever funds are needed toward setting up whatever life insurance program is proper for you.
3. *Here you make some choices and possibly split up your funding*. Look at your company pension plan first. If it has a matching program, then contribute at least as much as needed to get the company matching dollars. If you are not required to contribute or you have no 401(k), then go on to home ownership. You will return to pension plans and IRAs, but first things first. At this point, if you do not own your own home, getting one should be your priority. (I am assuming that you do not have one of the situations discussed previously, where home ownership is not desirable.) After funding a matching 401(k) program, put every dollar aside to purchase your home.
4. *Look at your debt level*. Consult with a mortgage lender and see how much mortgage you would qualify for with your present debt load. If you do not qualify for a home within a reasonable price range in your area because of debt, all your efforts should be concentrated toward reducing debt. See Prosperity Point 1, on getting out of debt.

5. *If you own your own home, look at your company 401(k) again*. No matter what tax bracket you are in, always contribute enough to get full matching dollars available in the plan. Next, look at your tax bracket from the Chapter 4 worksheet. If you are in the combined state and federal brackets of 25 percent or above, contribute as much as you can to your company retirement plan, up to 75 percent of available 10 Percent Plus Solution funds or the maximum allowed by the plan. The remaining 25 percent should be used to begin and build a mortgage buster plan.

   If you are below the 25 percent bracket, allocate your 10 Percent Plus Solution funds:

401(k) or other contributory pension plan	40%
Mortgage buster	30%
Mutual Funds DABL portfolio	30%

   I know some people will disagree on me at this point. They will say everything should go toward funding 401(k)s and the likes. After all, that's why they're called retirement plans. Well, folks, look at it this way: everything is your retirement plan, and diversification is the key that makes it all work. One mistake commonly made is tying up too much money in a retirement plan to the detriment of other financial independence accounts. The answer is to have flexibility with multiple streams of income available, not to have the majority of assets locked into a retirement plan.
6. If your *mortgage buster system* is moving along nicely, with at least a quarter of the amount needed to take over your mortgage payments, and you have an equal amount in a mutual fund portfolio, maximize your 401(k) contributions if you aren't doing this already.
7. If everything is cranking on all cylinders, with emergency funds, life insurance, pension plans, home ownership coupled to a mortgage buster, and a substantial amount in a diversified mutual funds DABL portfolio, it's now time to take the next step and begin investing in individual stocks through dividend reinvestment plans. See the Chapter 10 on DRP plans for explanations and specific advice. Stop investing into the mutual funds, and begin building your stock portfolio.
8. If your investment pyramid is complete up to a substantial stock portfolio, using dividend reinvestment plans, the next step is real estate investing. Read Chapter 11 on real estate, and determine if it is right for you. If real estate investing is something you don't want to do, then continue building your mutual funds and stock portfolios in equal parts.

Progressive Plan of Action

At this point, you have accomplished the following:

- Made certain you have completed (or begun) the earlier sections of the Progressive Plan of Action.
- Built your assets systematically, steadily going through each financial season, building your investment pyramid one block at a time, until you reach financial independence.

"Learn from the past. Live in the present. Plan for the future."

—*Bits & Pieces* magazine, June 17, 1999

CHAPTER 9

Life Insurance

It's a balancing act, trying to get the right mix of life insurance and retirement savings. The answers are not always clear, and companies pushing their own agendas add to the confusion. This chapter will present a guide to finding the proper mix for your situation.

THE CAR OR THE HOUSE?

John C. came to see me on his father's advice. His dad was (and continues to be) a long-time client. When his father retired a couple of years ago, John took over his butcher shop, added a deli and beverage section, and was doing very well. John's thoughts had turned to financial planning; he had spoken to some people and now was completely confused.

A salesperson from a large national financial company had recommended some stocks and mutual funds, an IRA, and a basic one-year renewable term life insurance policiy because as the salesperson/advisor said, "You won't need it that long if you buy term and invest the rest." John also spoke to an agent from one of the big life insurance companies who recommended a very large life insurance policy that the agent said "covers everything, and is all you need to retire on." John was confused by the conflicting advice and wanted another opinion from an independent source, so he came to see me.

"Which is better John, your car or your house"? I asked.

"Huh?"

"I mean suppose you had to choose just one? Your house may be comfortable, but it won't move. That means you'll have to walk everywhere, which will make life very difficult. On the other hand, your car will get you everywhere comfortably, but it's miserable for a family to live in. So which is better?"

Now a little glimmer of understanding started showing in John's eye, so I went on.

"As you can see, John, the question is bogus and can't be answered. A car and a house are different things serving different needs. Actually, you need both of them, and you can't give one up in favor of the other. You may compromise to satisfy your budget by owning a smaller house or buying a less expensive, maybe used, car, but you can't give up one in favor of the other. It's the same thing with life insurance and investments. They are different things and serve different needs. You have a family, and you need life insurance. You want to put your kids through college and become financially independent some day, so you need investments. You need both, and shouldn't give one up in favor of the other."

And that is one of the biggest problems with life insurance. In order to boost sales and increase profits, insurance companies and their agents have been pushing products that are favorable to the insurance companies and often detrimental to the consumers. This has been at the heart of the large fines and class action lawsuits levied in the 1990s against major companies like Prudential, Metropolitan Life, and many others. One of the tactics used is to blend investments into large insurance policies, giving the impression that it's really just mutual funds you can retire on and the insurance is just incidental. The motivation is simple to figure out. If an agent sells a large variable life insurance policy, the commission will range from 45 to 65 percent or more of the first year's premium, depending on the company and the agent's total production. If an agent sells a much cheaper term policy combined with mutual funds, the commission averages 40 to 55 percent of the much smaller life insurance premiums plus an average of 4 to 5 percent of the mutual funds. It's quite a difference. These policies are promoted by the insurance companies because they increase company profits while passing much of the risk to the unaware consumer.

On the other hand, you have the investment people who want you to buy as many investments as possible and spend very little on life insurance so you have more for investments. That has a certain appeal, but it is also false and a decision often regretted later in life. So here's the word.

> *Life insurance is life insurance and should be determined by need and/or the desire to leave a greater legacy. It can serve needs that investments cannot meet and works best when separated from investments.*
>
> *Pure mutual funds are investments and will provide returns far exceeding those within a life insurance policy. Investments work best when separated from life insurance. However, investments cannot provide the benefits of a life insurance policy.*
>
> *Investments and life insurance work best when separated. But like the house and the car, both are usually needed.*

Now it is time to take a look at individual life insurance policies and how they work. Then I will move on to constructing an effective life insurance program.

TERM LIFE

Term life insurance is the purest and simplest risk management. You pay the premiums for a year, and if you die, your family gets a large cash amount called the "face value." If you don't die, you pay again the next year and every year until the policy expires. Term life insurance is sold for a specific period of time called a "term." This can range from one to 30 years. The cheapest policies are for one year but they increase in price each year. Such policies are excellent for specific cases such as a business venture where a large life insurance policy is needed for a year or two. Short-term policies are unsuitable for family requirements where insurance will be needed for 10, 20, or 30 years or more. Even though these policies have a "guaranteed renewable" rider that can be purchased, that is, health tests are not needed to renew each year, there is a mathematical progression in the cost of premiums as illustrated in Figure 9.1.

The most effective use of term policies is to have a long term where premiums are guaranteed for 10, 20, or even 30 years. Of course such policies are more expensive than the one-year term, but they fit a need for relatively inexpensive life insurance, guaranteed never to go up during those years of high need when you're raising children, paying down mortgages, and trying to reach financial independence.

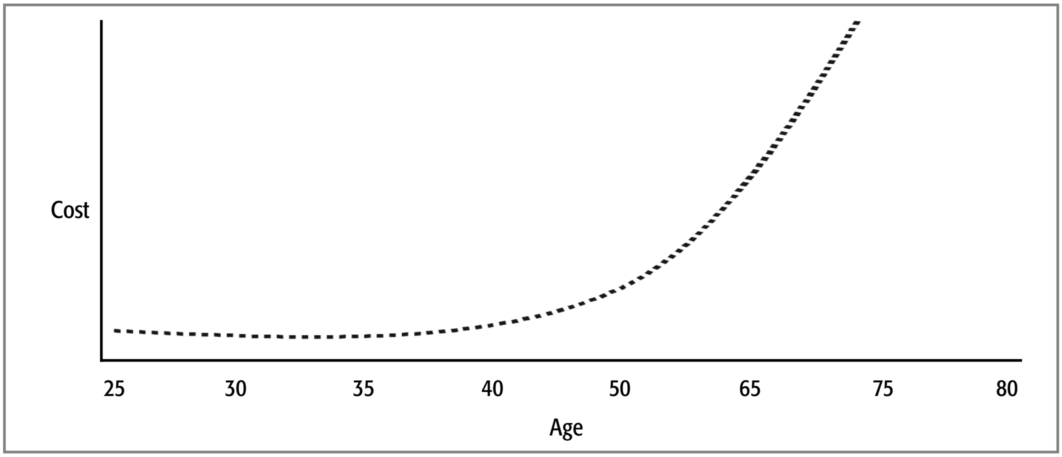


FIGURE 9.1 Life Insurance Cost Geometrical Progression

As you will see, long-term guaranteed premiums are a vital cornerstone of an effective program.

WHOLE LIFE

Also called "ordinary life," this is the traditional type of life insurance and in my estimation the best permanent type when done right. It is called "whole life" because it is designed to offer protection for the person's "whole" life, from young ages to age 100 for the same guaranteed premium. I recommend everyone have a small whole life policy for the future. I have counseled many older folks who still had a need for life insurance at older ages, but were unable to get it because of the higher cost at older ages, or because of the myriad of health problems people develop as they age. There is more on whole life in the section on life insurance planning later in this chapter.

UNIVERSAL LIFE

This type of life insurance was developed in the 1970s, and highly promoted in the 1980s. It continues to this day. In the late 1970s, interest rates reached historically high proportions as the Federal Reserve struggled with rampant double-digit inflation. A cornerstone of whole life insurance sales had been the favorable buildup of cash values in policies. But because it was, after all, life insurance, companies could not match the 12 to 17 percent returns of guaranteed instruments like CDs. Agents and companies were unable to switch gears and concentrate on the needs and benefits of life insurance, so they saw their sales drop. Consequently, the insurance companies came up with universal life, which they simply love because it has become a cash cow for the industry. A typical universal life policy consists of three elements bundled together in one policy. I call it "hidden" because if consumers knew exactly how these policies work, many would not buy them. Here are the three components of universal life:

1. *Company fees and expenses*. These costs come out of the premiums and go to pay company expenses in selling, maintaining, and servicing policies. For the average company, that's okay. Of course, like anything else in life, some companies will abuse this. Most do not, however, those expenses are a factor to be considered and are usually revealed (once you get through the mind boggling small print and jargon) within the policy document.
2. *Mortality costs*. This is the basic problem with universal and universal/variable Life. The mortality costs are not fixed and follow the geometric progression chart shown in Figure 9.1. In fact, it gets worse. Many companies charge higher mortality rates for universal life then for their term product, and because the costs go up each year, the company has much less risk than if it guaranteed a mortality rate for 10, 20, or 30 years. The costs are hidden in the Table of Guaranteed Mortality Cost. Every universal life (UL) and variable universal life (VUL) has one. It contains a dizzying array of numbers that will give the mortality costs per month, per $1,000 of insurance. Many agents and just about all buyers of ULs and VULs have no idea what this is. I will show you how it works shortly.
3. *Account at interest*. After deducting company expenses and monthly mortality costs, the balance goes into an account at interest. The interest is usually competitive for most companies, in addition to being tax free. But don't get too excited; look at the Figures 9.2, 9.3, and 9.4 on cash flow to see how it works.

Figure 9.2 shows how every premium payment is distributed in three parts. The first goes to paying company fees built into the policy. The second pays mortality costs, which is basically annual renewable term life with the costs rising each year. The actual insurance costs are also higher inside a UL policy than for straight term life. The third component, whatever is left over after paying the fees and mortality costs, goes into an account at interest. The interest rates vary according to the company, but they are generally competitive and have a minimum guarantee, which is usually 3 to 4 percent.

The idea is that while you're young, mortality costs will be low and the account will build value. Sounds good, but Figure 9.3 shows what happens when the policy holder gets older:

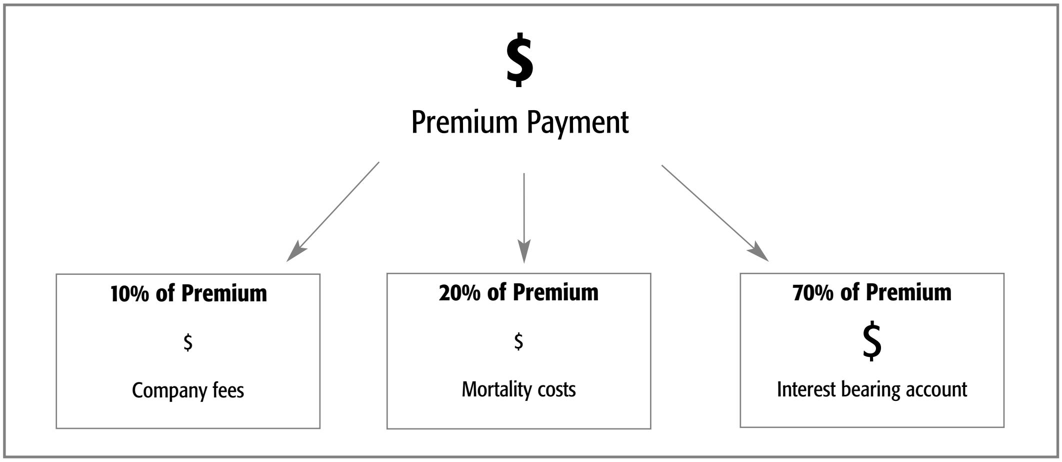


FIGURE 9.2 Universal Life Cash Flow in 20s and 30s

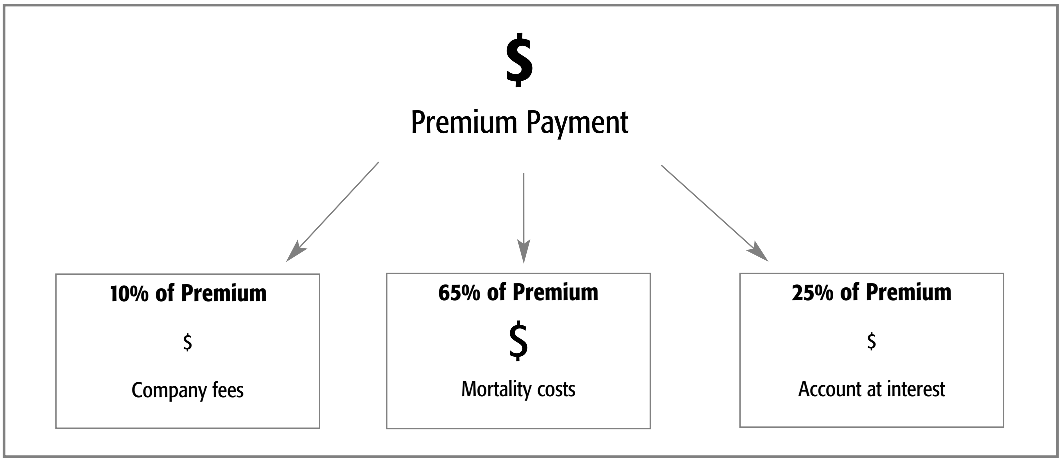


FIGURE 9.3 Universal Life Cash Flow in 40s and 50s

Now you see considerably less money going into the account at interest, because most is now going for mortality costs. As the person ages, the geometric progression of mortality costs becomes greater than the premium payments. The process is reversed, and money has to flow from the account at interest.

The policy reaches a point where the mortality costs become greater than the premiums. As Figure 9.4 shows, the difference is taken from the account at interest. Eventually, as the person reaches older ages, the account gets wiped out.

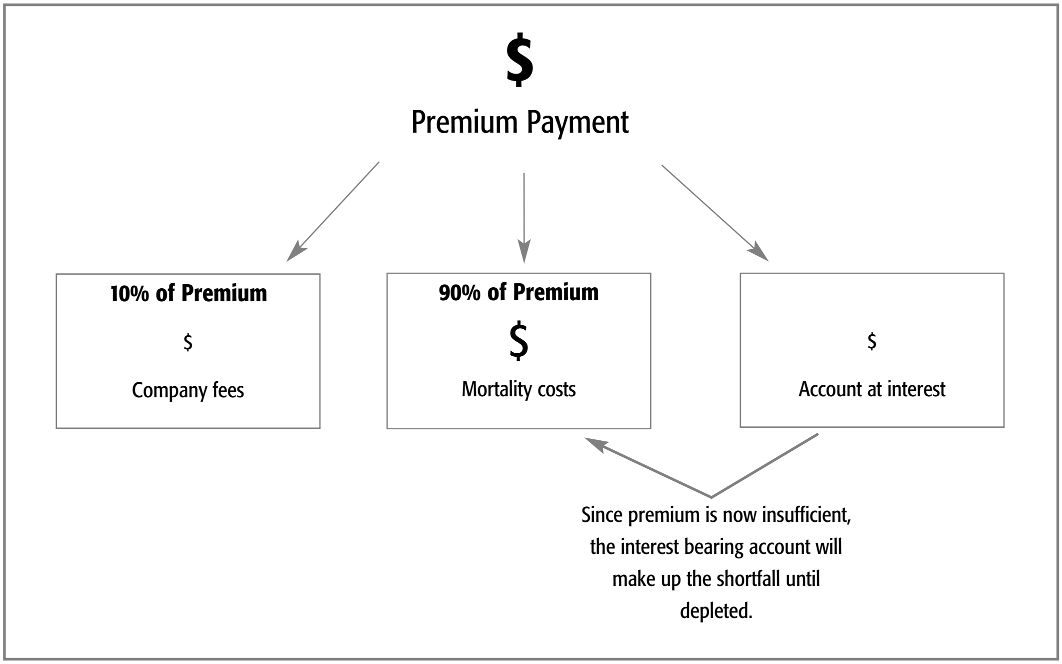


FIGURE 9.4 Universal Life Cash Flow in the 60s and Beyond

In the 1980s many of the companies and agents promoting universal life used completely unrealistic interest rates to "illustrate" how the policies would build large amounts of cash *and* provide life insurance forever. Well, folks, there's no such thing as 12, 16, or 18 percent fixed interest rates forever. The norm varies from 5 to 7.5 percent at best. In the 1990s many of these policies crashed. With cash values wiped out, many policyholders faced huge annual premium increases to keep the policies in force. The result was a spate of class action lawsuits and disciplinary actions against many of the large insurance companies. All universal life policies have the equivalent of this table somewhere in their pages. Consumers and even insurance agents don't pay attention to it, yet it lies at the heart of the problems with UL policies

Table of Guaranteed Maximum Monthly Cost of Insurance per $1,000

Figure 9.5 indicates the maximum amount the company may charge for mortality cost. While most companies do not charge the full amount, some do, and all follow the pattern of rising mortality costs. The numbers in Figure 9.5 are taken from a universal life policy from a major insurer. The policy was for $100,000, for a 40-year-old who was told he would have lots of money to use from the insurance

Age	Monthly Rate per $1,000	Maximum Cost of Insurance
40	0.19854	$19.85
50	0.42856	$42.86
60	1.11425	$111.43
70	3.08859	$308.86
80	8.54719	$854.72

FIGURE 9.5 Mortality Cost

policy at age 65, and would keep the insurance for life with a premium that would *probably* (because precious little is guaranteed on these policies) never go up. Figure 9.5 shows the information from the policy, with a target premium of $68 per month. (This is the premium suggested by the insurance company. Remember, they do not guarantee it will be enough. They "target" what they estimate will be sufficient. The actual risk is all yours!)

By the time age 60 is reached, money will be flowing out of the account to pay mortality costs because premiums are insufficient. Somewhere between ages 55 and 80, this person will face the choice of putting considerable amounts of money into the policy or having it lapse and losing it. Although most companies do not charge the maximum, they are not very far from it, and the results are almost as bad. Consider the sad case of Mr. W., a client of mine.

Mr. W.'s Universal Life Insurance Policy

On August 13, 1984 Mr. W. purchased a universal life insurance policy from a well-known national carrier. The policy had a face value (death benefit) of $135,000 and was issued at what the company called "preferred plus," a rating reserved for those in perfect health. Mr. W. was 63 years old at the time, and his purpose was not protection. He had chosen a pension that provided full continuation of pension benefits for his wife if he died, and along with her Social Security, the house with the paid-up mortgage, and their modest savings, she would be just fine. The reason the couple wanted the insurance was simply to leave a greater legacy behind. They had three children and several grandchildren (eight as of 2004), and they just wanted to leave them more. As Mr. W. said to me, "It was to be our final gift to them all." The couple's reasoning went like this: The premiums were $4,065 per year, and they could afford it. If Mr. W. died prematurely, the

$135,000 would be the kids' and grandkids' immediate gift. If he lived 25 to 30 years, he would have paid a $101,625 to $121, 950 so his family would get the gift no matter what. Or so he thought. If he lived to a ripe old age, as they are both doing now, the company's hypothetical illustration showed the policy would be well funded and make money until W.'s 99th birthday! None of this was guaranteed. The guaranteed section was missing, and the rate used was 12 percent. In 2003, the company's rate was 4.55 percent and dropped to 4 percent in 2004. Competitive rates to be sure, but nowhere enough to keep this policy from collapsing. On August 13, 2004, the W.'s received notification from the company that the next premium payment would be an astounding $14,078.36 to keep the policy in force for just one more year. At age 63, Mr. W. should never have been sold this policy. For his intentions, a whole life with the built-in guarantees would have been appropriate.

In response to the outcry caused by the collapse of these policies, companies have created riders that prevent the policies from lapsing or have recommended higher premiums. The cost of the riders or the higher premiums result in greater expenses over the life of the policy than if you purchased a true whole policy. The best policy is still traditional "participating" whole life (participating means the policyholder receives dividends and participates in the favorable experience and profits of the company, although dividends are not guaranteed). It is ultimately the least expensive product for those needing or wanting life insurance into old age.

VARIABLE UNIVERSAL LIFE

Variable universal life works like the universal policies described above, but instead of an account at interest, portfolios of mutual funds called "Variable Sub-Accounts" are offered. The idea is that now with the power of stock market investing, consumers will be able to get double-digit returns, build wealth within the policies, and have insurance and cash buildup for life. Sounds nice in theory, but outside of a few exceptions, I have yet to see these policies work as they say.

I'm not the only one who feels this way. An article in the August 1995 issue of *Worth* magazine (page 111) quotes Jack Bowers, editor of the independent newsletter *Fidelity Monitor*, "restrictions of investment options result in systematic investment underperformance for the holders of VUL policies." Further in the article (page 111), James Hunt, an actuary with the insurance group of the nonprofit Consumer Federation of America states, "mortality charges alone which are often not listed in the prospectus can greatly exceed the cost of term insurance. Broker commissions, management fees, monthly and administrative costs may further reduce performance by 2 to 5 percent." A chart in the article entitled "More Risk, Less

Returns," also from the Consumer Federation of America, shows whole life outperforming returns of variable life after 10 years and continuing past 20 years. That's why the article was titled "It May Be Variable, but Is It Profitable?" Obviously it is profitable for the insurance companies.

My experience advising clients who own these policies reveals another, deeper problem: Because these policies have stock market-based investments, they require management to be effective. In many cases, the insurance agent sells the policy, then disappears, leaving the policyholders to fend for themselves with often predictable and poor results. One agency of a major insurance company in Long Island would set the accounts at 50 percent guaranteed and 50 percent aggressive, a formula sure to bring horrible investment results. During the stock market shakeout of 2000–2002 holders of VUL policies received a nasty shock as the cash value of their VULs dropped like stones, jeopardizing the futures of their entire life insurance programs. The shareholder takes all the risk while the companies take all the profits. No wonder insurance companies love it. I do not recommend VUL under any circumstances. If you want VUL, you can create a more effective policy yourself by purchasing 20- to 30-year guaranteed term and coupling it with a mutual fund portfolio using the DABL system. You will have the protection of life insurance and the performance of pure mutual funds. The only thing you won't be doing is putting money in the coffers of insurance companies.

TAX ADVANTAGES

Yes, life insurance has definite tax advantages. These advantages fall in two general categories: tax free death benefits and the ability to take earnings out of life insurance tax free by using policy loans. If you use term insurance, the death benefits will continue to be received tax free; there's no disadvantage there. On the other hand, policy loans take from the value of the policy and reduce the benefit if not paid back. Still, the funds are tax free, and that's an advantage. However, the advantage may be derailed because policy loans can create a tax situation at death, and the new tax laws, with the favorable treatment of capital gains at 15 percent and preferred dividends also at 15 percent, make the tax bite more acceptable. The costs and problems of universal and variable universal life far outweigh the tax advantages they carry.

Please understand that I am not a proponent of "buy term and invest the rest." I have studied that belief and found it simplistic, and it leaves a whole new set of problems in real life. One of the biggest problems is human nature. People will buy term and spend the rest, winding up later in life with a need for life insurance and unable to buy it because of its greater cost at older ages or when there are health problems. Remember that life insurance is age- and health-based. Older ages render life insurance unaffordable, and health problems make it unattainable. Not having a permanent whole life policy in place may effectively cut out the future, rendering a person unable to purchase any if needed later on. Of course, everything is a compromise between the cost and the quality of the insurance product. The best compromises I have found are using combinations of policies, terms of varying guaranteed length, and a smaller whole life policy to assure availability of insurance at older ages. Along with that, of course, is building mutual fund portfolios for financial independence. It is the best compromise available when funds are limited. And aren't they always?

The requirement for life insurance may be described in two ways: needs and wants. The first is measurable, something tangible that we can plan for. The need is to replace the income that a person's family depends on to maintain its lifestyle and to achieve those goals that the person's income would have achieved, had he or she lived: funding a child's or grandchild's college education, assuring a spouse's retirement, and generally making sure that the financial side of the family and dependents' lives go on as before. Life insurance will replace the income that the individual would have provided for many years. That's income-based need. Then there's asset-based need. This is the need to acquire an asset, such as a house for survivors to live in, or perhaps paying off a mortgage that is no longer affordable on the existing family home. When properly calculated, filling an asset-based need will also supply the needed income by providing the assets from which the income will be derived. Total need determines the amount of life insurance you *must* have.

Life insurance want is the desire to leave a greater legacy behind, to accomplish in our parting what we may not have had the resources to accomplish in life. Leaving behind a large trust fund for the benefit of grandchildren, leaving a bequest to a favorite charity without depleting an estate, or providing the seed money for a private foundation, the wants are as many as the individuals carrying them. It is the fulfilling of dreams well past the need for financial independence and security.

For the average family, the need for life insurance will resemble a bell curve—rising high, staying high for many years, and then dropping off to lower needs. See Figure 9.6.

If you are single and young, just starting out with no one depending on you for anything except perhaps expectations, the need just isn't there. But then you meet your sweetheart and get married. Now you have a need, not very much to be sure, just enough to tide over the love of your life so he or she can start anew if you are taken unexpectedly. Working together, you make progress, and you buy a house. Now three parties own the house—husband, wife, and the bank, mostly

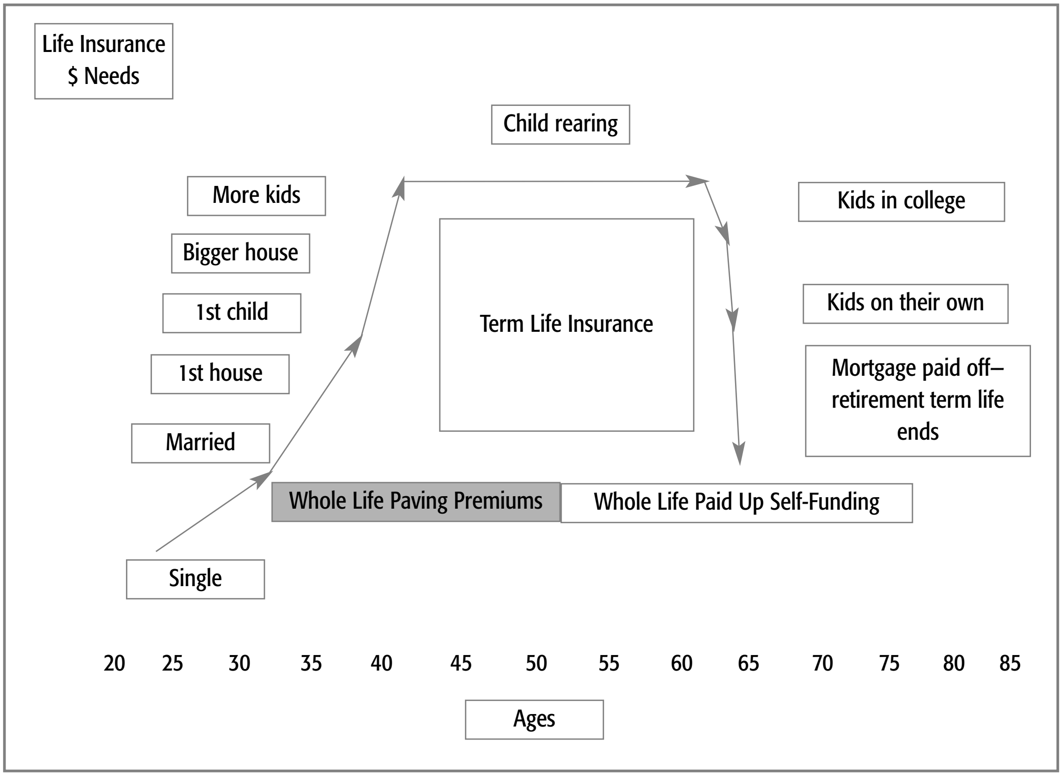


FIGURE 9.6 Life Insurance Needs Bell Curve

the bank. Now the need is ratcheted upward. If something happens to one person, the other is left holding the bag for the mortgage, so the need has just reached well beyond a small tide-over sum. In addition, by that time, each partner has gotten used to a certain lifestyle. So you must consider a further need: Does that lifestyle come mostly from one partner with the other as a supporting spouse, or is it a combination of two incomes? If one of the two incomes disappears, the survivor may face a diminished lifestyle. If most of the income comes from one partner, how will the survivor fare without that income? This has brought you up on the bell curve, but now comes the greatest leap of all: children.

The incredible cost of nurturing a child from birth to college and eventual (you hope) maturity and self-sufficiency must be considered. Children are a quantum leap on the life insurance needs bell curve. More children raise the curve dramatically.

Time passes, children grow up, and assets build as you march on toward financial independence. Now the bell curve starts a downward descent as need diminishes, until it reaches levels almost as low as when you started out. Almost, but not quite. There is always a need to cover final expenses without depleting assets, that quick infusion of tax-free cash, smoothing out the financial transition for the survivors. To fill the needs of that bell curve efficiently, a combination of products is needed. No matter what the insurance companies try to tell you, there is no one product that will do all that without putting money into life insurance to the detriment of other needed investments. In my estimation, a combination of two products works best for most people: A large, inexpensive term policy, guaranteed for 20 to 30 years, and a much smaller whole life policy for the later years. Generally, the whole life will comprise 10 to 20 percent of the entire insurance and provide protection for older years, whereas the term life will protect during the high-need years. A combination of such policies will provide all the protection needed at a minimum cost. By the time older ages have been reached, the person will be on the lower end of the bell curve, need will have diminished considerably, and the term policy can be dropped. By that time the whole life will most likely have reached a stage where it can fund itself from dividends and earnings within the policy, which vary by insurance company. Below are guidelines for the mix during the individual seasons of money.

Spring

In the early part of spring, the accumulation years, growth of investments *and* protection is of paramount importance. Compromises must be made, and the budget may simply not allow for the ideal mix of life insurance. For the early years, it's okay to start out with inexpensive term life as long as the person realizes that as soon as the budget allows, permanent whole life should be added. This should be done while the person is young and healthy, and the policy affordable. One of the worst planning mistakes a person can make is delaying the purchase of a whole life policy, winding up with a need at an older age and an inability to afford the cost. Children/grandchildren may still depend on you at older ages because of illness or any of the curves that life is apt to throw us.

In the later stages of spring, when assets begin to accumulate, whole life should be added to comprise about 10 to 20 percent, or at least $100,000.

Two riders are an *absolute must* for both policies and are generally inexpensive. Make sure you have both riders: guaranteed insurability and disability waiver of premium.

GUARANTEED INSURABILITY. This rider assures that you will be able to purchase more insurance without health consideration. Purchasing a small whole life policy with this rider will allow you to increase the policy in later years, even if you have developed health problems.

Disability Waiver of Premium. With this rider all premiums will be paid for the term of the policy if the insured becomes disabled. In the case of whole life, premiums are usually paid to age 60, thus providing not only life insurance, but also putting cash into the policy.

Summer

In the financial season of summer, you are between 75 to 100 percent of having all of the assets needed for financial independence. Term life can be reduced to cover just that smaller remaining amount. Most term life companies will reissue the policies at lowered face values when requested. Whole life should be in place and perhaps increased if a need at later ages becomes apparent.

Fall

The financial season of fall is independence, freedom. Wants become more important, especially the desire to leave a greater legacy behind. Needs may still exist, and each individual should examine the questions: From a strictly financial point of view, who will suffer if I die? Who is depending on me for support? The answers to those questions will determine the need.

Winter

A person in the financial season of winter has 100 percent or more of the assets required to provide income without working. It is the season that wraps around all the other financial seasons, the succession planning, preparation for transferring all you have accumulated to those you love. Estate planning is covered in Chapter 13.

Go to Worksheet 4 (page 229) and complete the life insurance needs section. There you will find specific recommendations as to products and companies so you will know exactly what to do.

Progressive Plan of Action

At this point, you have accomplished the following:

- Made certain you have completed (or begun) the earlier sections of the Progressive Plan of Action.
- Examined your life insurance needs and wants for each season. Using the specific recommendations and worksheets, you have built a commonsense life insurance program to protect your family now while leaving open the door to future needs.

"I'm proud to be paying taxes in the United States. The thing is, I'd be proud at half the money."

—ARTHUR GODFREY

CHAPTER 10

Qualified and DRP Plans

People who want to retire will find the government participating less and less in retirement funding. However, the government has given us the tools to help prepare for retirement and help us reach financial independence. Those tools are called qualified plans and we will examine them in this chapter along with an effective method to invest in individual stocks while remaining within the protective shelter of the DABL system.

QUALIFIED PLANS

In previous chapters, you examined when contributions should be made to a qualified plan, and the place such plans hold in the investment pyramid. You may recall that a qualified plan is one that has been

approved, or qualified, by the IRS as a tax deductible retirement plan. While there are many kinds of qualified plans, we can classify them in three general categories: employer-sponsored plans, self-employed qualified plans, and qualified plans for individuals and employees.

Employer-Sponsored Plans

This type of plan is carried by the employer who is responsible for its administration, IRS reporting, and following the complex rules for such plans. If you are an employee and get a W-2 report of wages at the end of the year that you use to file your income taxes, you have no control over the kind of plan your employer has. You may direct the investments available for your account within the plan, but you do not have a choice as to the kind of plan it will be: SEP IRA, 401(K), defined benefit, or defined contributions. Whatever plan it is, it's strictly up to the company to choose. Also up to the employer is whether or not the company will contribute or obtain all contributions from employees' salaries. As an employee, when contributions are taken from your paycheck to fund your retirement account, they are removed from income taxation at both the state and federal levels. With the exception of Section 125 plans, which are benefit plans, all qualified plan contributions are still subject to Social Security and Medicare taxes. That's why when you look at a W-2 where contributions have been made to a qualified plan, Box 1 will have the gross amount subject to income taxation. The boxes directly following will have a greater amount taxable for Social security and Medicare. The difference is the contributions to the qualified plan.

If you are an employer, choosing and implementing a qualified plan for your firm is a complex decision well beyond the scope of this book. Both employers and employees should be aware that strict regulations against discrimination (one class of employees, such as managers, receiving greater contributions than another class, such as laborers) are vigorously enforced by the IRS. Another set of regulations called "top heavy rules" is also rigorously enforced by the IRS. Top heavy rules assure that higher paid employees cannot receive proportionately greater contributions than employees receiving lesser compensation.

All qualified plans fall under a complex set of protective regulations called ERISA (Employee Retirement Income Security Act.) Passed in the 1970s, ERISA protects qualified plans and employee pensions against abuses like those that occurred in the 1960s and early 1970s. Warning: Be warned that while ERISA may protect against abuse and outright thievery, it will not protect against bad investment decisions. That remains up to the individual participating in the plan. It's up to you to invest wisely. Follow my DABL plan, get professional help if needed, or spend the time necessary. Investment results are strictly up to you and/or your advisor, if you have one.

Self-Employed Qualified Plans

If you are self-employed, you have access to an entire class of qualified plans. Many of these plans mirror employer-sponsored plans. As the self-employed person, you become both the employer and employee. For the purposes of these plans, a self-employed person is one who receives one or more Form 1099s instead of a W-2 or derives income from customers not required to issue 1099s. (A 1099 is an IRS form that certain businesses are required to file informing the IRS that compensation has been paid to nonemployees.) The range of people eligible is pretty wide—from the insurance salesman who sells the products of one company but is not considered an employee to the real estate broker operating as an independent contractor within a large firm, to the landscaper with dozens of individual customers.

A note of caution before you go further: If you hire someone, you are no longer just self-employed. You are also an employer, and the rules are different. Basically, you must contribute at the same rate for your employee as you do for yourself. So the insurance salesman who hires an assistant or the landscaper who hires one laborer becomes the employer and must contribute for the employees in the same proportion as for himself or herself.

All the mutual fund families I have recommended, such as Fidelity and Vanguard, have prototype plans already established and approved by the IRS, which will furnish all the needed forms as well as provide telephone assistance with questions. The cost is minimal, usually $10 to $25 per plan.

The qualified plans available for the employer with hundreds of employees are also available for the self-employed with no employees, or just one or two. However because of costs of administration, they are simply not practical. The following are the qualified retirement plans that are appropriate and available under current law for the self-employed with few or no employees:

- *SEP IRA*. Simplified Employee Pension plan has no administration outside of basic information on forms from providers and deadlines for establishment and funding. The limits for funding are 25 percent of earned income up to a maximum of $41,000, so someone earning $250,000 would be limited to $41,000 not the 25 percent, which would be $62,500. If you have an employee and set up a SEP, you must contribute the same amount to your employee's SEP as you contribute for yourself.
- *SIMPLE IRA*. This plan is also easy to administer, but requires filing Form 5500 when the plan reaches certain limits. Your mutual fund provider will have detailed information on this. SIMPLE Plans have limits up to $9,000, for those under age 50 and $10,000 if over. In addition, 3 percent of contributed amounts may be matched by the employer. If there are no employees, the self-employed person essentially makes the contributions to himself

or herself. Here's a key advantage of a SEP IRA: It may be 100 percent of earned income up to the maximums of $9,000 or $10,000. In certain cases, that can be a great advantage.

Stan is one of my clients. He is 52 years old and works construction for Local 138 of the operating engineers, running bulldozers and other construction machinery. He also sells real estate part time and wanted to put away everything he earned in real estate for his retirement. He is in a high tax bracket and averages between $12,000 and $15,000 net after expenses selling real estate. (Self-employed earnings are always considered net after expenses as reported on Schedule C, the self-employment schedule of Form 1040.) John puts $10,000 plus 3 percent of his earnings in a SIMPLE IRA, leaving only a small taxable amount. Its administration is only slightly more difficult, requiring only that a Form 550 be filed annually when the plan reaches a certain dollar amount or has a certain number of employees. Under current law, SIMPLE IRAs must be established by October 1 of the year in which it will be used and funded by September 15 of the following year.

- *Keogh Plans, Money Purchase/Profitsharing Plans, and Individual 401(k)s*. These plans all allow a percentage of earnings for contributions, currently up to 25 percent on a maximum income of $41,000. So the main difference between these plans and a SIMPLE IRA is that you can contribute $10,000 (assuming you are over 50) to a SIMPLE IRA if you earn $10,000, whereas for the other plans you must earn over $40,000, because only 25 percent of income can be used. Profitsharing allows greater flexibility for employers because contributions are based on profit, thereby allowing lesser contributions during lean years.

Qualified Plans for Individuals and Employees

The qualified plans covered so far are employer-sponsored plans. That is to say if you are an employee, you cannot have one of those plans unless the company sets it up for you. The following qualified plans may be used by individuals. Some may only be available for self-employed people while others may be used to supplement company retirement plans.

TRADITIONAL IRA. This is the old standby, available to everyone. Limits under current law are $3,000 with catch up provisions up to $3,500 for those over age 50. The IRA is deductible up to the amount of earned income. That means if you are over 50 and earn $2,000 you may deduct only $2,000. You must earn at least $3,500 to get the full deduction. Another restriction is the phasing out of deductibility if you have a retirement plan at work. The amount you can deduct on your taxes is gradually phased out according to earnings until it vanishes at certain income levels.

Do not contribute to an IRA unless you can deduct it in full. I mentioned this earlier, but it bears repeating. IRAs have baggage that has to be carried. Anytime you take money out of an IRA, it is fully taxable; and if you are not over age 59½, there is an additional 10 percent penalty. You *must* begin withdrawal at age 70½, and be taxed, whether you need the money or not. So why carry the baggage if you don't get the benefit of deducting it? It doesn't make sense. The argument is often made that the money grows tax free until you use it. This argument does not hold up under close scrutiny. If you are in a high tax bracket, there are better vehicles, and now under the new tax laws, the tax burden has been greatly reduced. Capital gains and qualified dividends are limited to 15 percent, whereas taxable funds removed from IRAs are taxed at ordinary income rates averaging 25 percent and up. Even if you are in the lower tax brackets (10 and 15 percent), you may want to consider whether a meager tax saving is worth tying up your funds in an IRA.

ROTH IRA. Think of a Roth IRA as a traditional IRA in reverse. You get no immediate benefit, no deduction on your Form 1040. The benefits start with tax-free growth, earnings, and tax-free withdrawals. Individuals must have left the funds in the plan for five years and reached age 59½ before making tax-free withdrawals. Furthermore, the Roth IRA is not subject to minimum distribution rules during the owner or heirs' lifespans. This makes the Roth multigenerational and a fantastic tool for passing wealth on to future generations. Traditional IRAs may be converted into Roth. However, this will result in a taxable event, and care should be exercised. People contemplating converting traditional IRAs to Roths should consult their tax advisors first. There are a number of rules favoring tax-advantaged withdrawals of IRA funds. First-time homebuyers, disability and other hardships, and substantial and equal distributions before age 59½, are just a few. These exceptions should not be applied to Roths because of the inherent future tax advantage Roths carry. Premature withdrawals from a Roth should be a last resort.

ROLLOVER/TRANSFER IRA. This is the vehicle used when you switch jobs and want to take your retirement plan with you. A rollover/transfer IRA is created, and the funds from the pension plan are rolled over, or transferred directly, into the new IRA. Because of the requirement for 20 percent withholding and the potential for a costly taxable event, I recommend direct custodial transfer. The individual fund families such as Fidelity or Vanguard will gladly help you with the paperwork and technical requirements. After all, they will be receiving the money in their mutual funds. If you work with a financial advisor, he or she will be able to handle all the paperwork for you. I *always* recommend transferring your retirement plan into an IRA when you leave your job. It gives you more control. It always makes sense.

Deducting Qualified Plans for the Self-Employed

All of these qualified plans are deducted "above the line" on page 1 of Form 1040, in the section "Adjustments to Income." Do not put them on your Schedule C, profit/loss for self-employment because like all qualified plans, contributions are not subject to income tax, but are taxed for Social Security and Medicare. The net profit from self-employment flows to Form 1040, Schedule SE that assesses the self-employment tax. If you have an employee, there is a space on Schedule C where you deduct salary, employee benefits, and other payroll expenses.

Deductions for Corporations, Partnerships, and LLCs

Many self-employed people are sole proprietors. They hold the responsibility and liability for potential business errors, leaving them open to tort (liability) lawsuits. For many occupations, that may be okay. Liability for a florist, a tailor, or other low-risk occupation may be minimal and a simple commercial liability or Errors and Omissions policy may be all that is needed. Other occupations carry a high liability risk that may expose business owners to lawsuits well above the protection of insurance policies. Auto mechanics, exterminators, contractors, and other high-risk occupations should have the protection of a corporation or LLC. (Risk management is covered in Chapter 12.) Now the issue is deducting qualified plan contributions against earnings. Regular corporations pay their own taxes and issue dividends that are taxed again. Although the new tax laws are more favorable, restricting qualified dividend taxation to 15 percent, it is still a double taxation. For the average corporation there is a 25 percent tax, a 15 percent to the individual receiving the profit in the form of dividends, plus another 5 percent in many income tax states. That's why most small businesses and self-employed people operate as a Subchapter S corporation. S corporations are called "pass through" entities because they allow the profits to be passed through to the owner to be taxed at the individual owner's rate. Earnings information is passed to the IRS by means of Form K-1 issued from the S corporation tax return.

Now comes the problem of earned income for qualified plans. Profit from corporate K-1s are not subject to Social Security taxation and are not considered earned income. In order to deduct qualified plan contributions, you must turn K-1 profit into payroll for the individual owner, which will trigger additional taxes in the form of Social Security, Medicare, state unemployment, and federal unemployment taxes. The individual must balance the tax benefit of qualified plan contributions against the cost of payroll taxes.

One simple solution is for the corporation to pay out profit to the owner and issue a Form 1099. The owner then reports this income on a Schedule C for self-employment without using deductions. Social Security/Medicare taxes would be paid on the full amount and plan contributions could be deducted against earnings. Individuals should be aware that the IRS does not like this and has repeatedly challenged funds being removed from S corporations by any other means than payroll. In 2003, a ruling was issued that stated a single-owner corporation could *only* pay out funds to the owner by means of payroll. This is a complex area. I recommend consulting a competent tax advisor to examine your individual situation.

Limited liability companies (LLCs) offer a much simpler and more effective solution for the self-employed or the single-person business. On establishing the LLC, the owner files a form with the IRS establishing a "disregarded entity" status. This allows simplification of tax issues as the IRS will now disregard the LLC for tax purposes, allowing the individual to file taxes as a self-employed person while retaining the liability protection of the LLC. For purposes of choosing a retirement plan, the person operating as a single LLC with disregarded entity status will simply file a Schedule C self-employment form. The only difference is that these people will add the letters LLC after their names. They will be eligible for Keoghs, SEP, Profitsharing, and any other plan available to self-employed individuals. If they have employees, the rules also remain the same. Equal contributions must be provided for each employee by law. Many small businesses and individuals are electing LLC because of this simplification. Readers should consult with legal and tax advisors before adopting a particular business form as needs vary for differing businesses. In addition, incorporations and LLCs are regulated by individual states, which affects the choices.

Defined Benefit Plans

All the plans I have discussed so far have been defined contribution plans, that is, the contributions made are defined in exact amounts, but the benefits at retirement are unknown and depend on the investment performance.

A second type of plan is called defined benefit because the retirement plan's future benefits are defined, and contributions must be made that will satisfy the retirement benefit targeted. This type of plan is favorable to older employees and self-employed persons. However, contribution schedules are more rigid, and IRS regulations more complex. To explore if a defined benefit plan is appropriate for your individual situation, a professional specializing in such plans should be consulted.

Retirement Plan Investments

People will often confuse the instrument with the investment that goes into it. I have often been asked, "Is a Roth (or an IRA or SIMPLE) a good investment?" The answer is that it is not an investment at all! It is a vehicle within which investments are carried. First, you determine whether you should have one (in most cases the answer will be yes), and then you open the account and put the investments into it. If you put good diversified investments in, you will get good results. If you put bad investments in, you will get bad results. Although the IRS places restrictions on the kind of investments that can be placed into retirement accounts, generally the entire gamut of standard brokerage investments are available: Stocks, bonds, options, limited partnerships, derivatives, and annuities are all permitted and available.

Whether you should invest in them or not is something else. I recommend caution and conservative, diversified investments for two reasons. The first is tax issues. If you lose money within a qualified plan, you can't even deduct it from your taxes because it has already been deducted. The second reason is even more important: it's your retirement! That's one of the accounts that will provide the income needed for decades upon decades of prosperous longevity. You simply cannot afford to squander it in aggressive investments, nor can you let it linger at 3, 4, 5, or 6 percent. The solution I always recommend is a basket of diversified mutual funds using the DABL system.

DIVIDEND REINVESTMENT PLANS (DRPs)

The next step in building your pyramid of investments is a portfolio of individual stocks using dividend reinvestment plans (DRPs or DRIPs). This is in continuance with our overall DABL system for managing diversified investments. I recommend not starting a DRP portfolio until you have reached a minimum of $100,000 in diversified mutual funds as described in the DABL section of Chapter 5. After you begin investing in DRPs, keep the relationship approximately two-thirds mutual funds and one-third DRP stocks. Maintain that approximate mix until you reach a combined minimum of $300,000, with $200,000 in recommended mutual funds and $100,000 invested in recommended DRP stocks. From that point, gradually increase your investments in DRPs while decreasing mutual fund investments until the mix reaches about half mutual funds and half DRPs. *Do not sell any mutual funds or stocks to reach this allocation*. Just adjust your monthly investments so most of it goes to DRPs until the right mix is reached. Continue to add DRP stocks from our recommended list and be sure to check the web site www.prosperousboomer.com as I will be adding new stocks.

This strategy will insure diversification by always keeping large amounts in mutual funds and adding more individual stocks in small increments. If you are investing a lump sum, invest the minimum in each recommended stock, or if your amount is sufficient to invest more than the minimum, invest equally in all the recommended stocks. If you are investing a monthly amount, start with one stock until you have the minimum required to open an account, then go on to the next one. Keep doing this until you have a minimum investment in each recommended stock, then continue to build your holdings in equal amounts.

Advantages of Dividend Reinvestment Plans

First, it's very unlikely that you will hear about these plans from your broker, even though they are one of the best ways to invest. The reason for that is because it not only leaves him out, but also encourages a buy-and-hold mentality. Although in the last few years most full-service brokerages like Merril-Lynch, Smith-Barney, and others have instituted dividend reinvestment plans for their clients, one senses they are not very enthusiastic about DRPs and only have them because the public is getting more educated about investing.

If you work with a stockbroker as a financial advisor, he or she will buy the stocks for you and generate commissions, then place the newly purchased shares in a DRP, usually one created by the brokerage house. If you choose to work with advisors, that's okay. But it must be understood that they deserve to get paid, and the commissions on the purchases will be their compensation. Use an advisor to help you purchase the individual DRP stocks I recommend, and *hold on to them*. That's what the "B" in DABL stands for: buy and hold quality. Most of the time, stockbrokers will recommend against it because the only way they can get paid is if you either buy or sell the stock. Buying is okay, selling is not, unless it is part of a coordinated plan and the stock has been held for many years, running up considerable profits.

This section is designed for people to do it themselves, to manage their own investments with specific guidance and recommendations. Others who choose to work with an advisor should use this section to provide guidelines as a means of checking on their advisors to make sure they are doing the right thing on your behalf and earning the money you pay them.

DRPs work like this: In most cases, you can buy the stock directly from the company by calling a toll-free number, getting an application and prospectus, filling it out, and sending in the first check. This is a tremendous advantage for the following reasons:

- *You can purchase a small initial amount, some times as low as $100 to $250*. If you bought such a small amount through a broker, it would be called an odd-lot sale and generate elevated commissions. You often pay $25 to $45 to buy $200 or $300 worth of a stock. That doesn't make economic sense. When you buy direct from the issuing companies, commissions are in proportion to the purchase and are very minimal. These companies *want* you to invest in them. It gives them operating cash, drives up values, and makes shareholders very happy. Many companies do not even charge fees or charge only nominal fees. Some companies even offer discounts where shares may be purchased slightly below current market rates.

- *Small amounts ranging from $25 to $50 may be invested at any time with the same low commissions.* This is great for someone who is dollar-cost-averaging (investing the same amount each month) and building up assets in modest monthly increments. It's simply impractical and too expensive to do that with a broker. You could do it with a mutual fund, but not with individual stocks, unless you are in a DRP.
- *Dividends can be reinvested*. Instead of receiving dividend checks and saving them until you have enough to purchase shares, the dividend is used to buy more shares, thus increasing the portfolio. Fractional shares are issued, which means that a dividend check may buy 3.5402 shares of a particular stock. Over time this can build very nicely.
- *There is ease of sale when needed*. Let's say you have approached financial independence and now it's time to convert some of your DRP portfolio to cash. Let's suppose you have 20 stocks each worth $5,000, and your income plan requires investing $20,000 into an income annuity. You may simply sell $1,000 worth of shares of each stock. It is inexpensive, and you can retain the diversification and integrity of your portfolio.

Even though DRPs are a wonderful method to invest directly in individual stocks while staying within the safety of the DABL system, since risk can sometimes be higher, and not all DRP stocks are good, I have compiled a directory of recommended DRP stocks and how to invest in them. You will find this in the Appendix at the back of this book.

Progressive Plan of Action

At this point, you have accomplished the following:

- Made certain you have completed (or begun) the earlier sections of the Progressive Plan of Action.
- Understood the investment power of dividend reinvestment plans, and if you have reached that stage, placed them in your investment pyramid.

"A gambler is someone who plays slot machine. I prefer to own slot machines."

—Donald Trump

CHAPTER 11

Real Estate Investing

Now that you have put together your investment pyramid with a strong foundation and with diversified investments using the DABL system and dividend reinvestment plans, you may be ready to go on to real estate investing. If you have come this far, you are probably in the summer of your financial season, closing in on freedom, or even better, you may have achieved it already.

So why would I say, "You may be ready?" Why wouldn't I just tell you to go on and invest in real estate as the next step to cementing your financial independence?

Because it's not for everyone!

To be a successful real estate investor requires hard work, research, good business sense, good cash flow, the ability and temperament to patiently ride out real estate down cycles, and the fortitude to be a landlord, which is what you will be in most cases.

First, let me put to rest the get-rich-quick idea, the notion that real estate is a can't-lose proposition and you can do it without any risk or money down, using OPM (other people's money) and a set of instructional tapes bought for four easy payments of $59.95 each from a late night infomercial.

Sure!

Ever see those half-hour commercials filled with ordinary looking people who tell you they made $89,000, $167,000, or $212,000 in 90 days with no money down? Yup, just three months ago they were living in a rented trailer, trying to figure out how to pay their electric bills, and now a few months later, they are testifying on television from their new mansion on the beach in Honolulu. Right!

Sorry, but I don't believe it. I have spoken to many groups, met hundreds and hundreds of people, and I have yet to meet one of those folks. Have you met any? Who do you know specifically who has done this? I don't believe they exist. Now don't get me wrong; I know plenty of people who made a lot of money in real estate. Some of my clients became millionaires investing in real estate. But I can tell you for sure that they worked hard at it, studied the territory long and carefully, took risks with their money, and backed the risks with sound business strategies and careful cash flow planning.

HOW DENTISTRY SAVED ROGER AND BETTY

Roger is a dentist, and his wife Betty is a dental hygienist. They have a very nice, lucrative practice that takes up the entire first level of their two-story home in Smithtown, Long Island, New York. The dental practice is what saved their bacon when they made their first real estate investment outside the home they live in.

Roger, Betty, and I have been mutual clients for many years. They take care of my teeth, and I take care of their money. In 1986, Roger and Betty felt they were ready to take the next step and invest in real estate. I agreed. In fact, I had urged them on after doing a cash flow analysis.

"Cash flow analysis?" said Roger. "C'mon, this is real estate, you can't go wrong, they don't make anymore of it, look how it's going up!"

I said, "Humor me, Roger." I'm funny that way. But the cash flow analysis turned out good, so we went ahead and invested.

Roger and Betty went looking, did their homework, studied the Long Island market, and made their first investment in September 1986, followed by another in November of the same year. The first investment was a starter home, a three-bedroom basic ranch in Rocky Point, Long Island. The house was in poor shape, and they had to invest an additional $18,000 to get it fixed up. The second investment house was new construction in the town of Middle Island, also in Suffolk County, Long Island. Roger bought a lot privately at a fairly low price and contracted to have a three-bedroom split-level built. There were delays, problems here and there, some cost overruns. The house was not completed until the summer of 1987.

The Rocky Point house rented pretty quickly, and while the cash flow was a bit negative (mortgage, taxes, and maintenance were higher than the rent collected), it wasn't high enough to be a concern. Roger and Betty estimated correctly that the rise in capital appreciation of the house would more than make up for the cash flow. Although correct, they just didn't realize how long it could take. Meanwhile, they were deciding whether to take the quick profit of about 15 percent on the new construction or to rent it for a few years and sell it later at a much higher profit.

In September 1997, the stock market crashed. The economic ripples of that event were felt throughout Long Island, as far away as Montauk Point at the farthest end. Before the crash, tens of thousands of people lucratively employed by Wall Street spent large amounts of money in Long Island, helping to pump up already inflated home prices. After the crash, it was said on Wall Street that the only one who could put a deposit on a BMW was a seagull!

It began to get tight for Roger and Betty's real estate investments. Potential buyers for the new home in Middle Island vanished. In February 1988, the tenant in the Rocky Point home stopped paying rent. He had lost his financial services-related job in nearby Huntington and started a series of part-time jobs at a fraction of his previous income. Rent came sporadically and never for the full amount. In mid-1988 Roger began eviction proceedings. Courts in New York are not favorable to landlords, and it was almost Christmas by the time his nonpaying tenant left. Meanwhile, the new construction sat there, sucking up mortgage payments. Not one potential buyer offered anything more than 80 percent of what Roger and Betty had paid. After several more long months of both houses sitting empty, they found tenants for each. They were forced to accept about 75 percent of the rent they originally thought they could get. Stuck with a stubborn, lowered real estate market, it would be eight years before prices started to climb and rents returned to their original levels.

What saved Roger and Betty was the high cash flow from the dental practice. They stopped investing, stopped contributing to the qualified retirement plan I had put together for them previously, stopped putting money into savings, and eliminated expensive vacations and other luxuries. But they survived because they had good cash flow. But what if they had not had that cash flow, what if they were just getting by, believing as many did in those days, that the local real estate boom would never end? The answer is that they would have joined the legions of folks who found out about real estate cash flow the hard way and turned to bankruptcies and abandonment of properties in the years between 1987 and 1994. The lesson to be learned from Roger and Betty's experience is twofold:

1. Real estate, like all investment markets, runs in economic cycles. Those cycles may be less severe, but are usually longer. Witness the decade-long tumble of Texas real estate values in the 1970s.
2. Cash flow is king. Cash flow almost bankrupted the savviest and wealthiest real estate investor of our time: Donald Trump. Be assured of your cash flow before investing in real estate.

CASH FLOW ANALYSIS

Before investing in any real estate, a basic cash flow analysis should be performed. You don't need a whiz of a CPA or a financial expert to do this; all you need is commonsense, realistic expectations, and the willingness to contemplate worst case scenarios. Here is a basic seven-step process for a real estate cash flow analysis:

STEP 1. What is the monthly cost of maintaining the property before you purchase it? Add up all the costs, maintenance, property taxes, utilities, management fees, and insurance, in short, everything it takes to operate the property.

STEP 2. What is the current income from the property before purchase? Consider rents, leases, etc. Be realistic in your assessment, and be sure the income is permanent and sustainable. Don't include short-term leases or other income that is unlikely to be continued.

STEP 3. Deduct expenses (Step 1) from income (Step 2.) This is your net cash flow. It can be positive or negative. In other words, there may be money left over each month, or cash may have to be added to make ends meet.

STEP 4. Now re-evaluate Step 1 *after* you purchase the property. Add in financing, improvements, additional property and other taxes from improvements, extra utility and maintenance costs, and other expenses that did not exist until you acquired and possibly improved the property. If you paid all cash, include 6 percent interest to yourself as a cost. After all, you will not receive investment income from that money. Add it all up for your total operating cost. *Be realistic!*

STEP 5. What will be the income after acquisition and improvements? After you add the extra apartment, fix up the place so it can be rented, after everything is done, what is the likely monthly income from rentals and leases? Pay attention to the local real estate rental market. Study it. *Be realistic!*

STEP 6. Now determine your net anticipated cash flow. Deduct anticipated expenses (Step 4) from anticipated income (Step 5). This is your anticipated net cash flow. It could be a positive or negative figure.

STEP 7. Now anticipate the worst. First, be sure you have been realistic; review your figures and estimates. Allow for the inevitable problems and cost overruns of improvements, and because interest cost estimates are accurate. Visit all the real estate offices handling rentals in the area and study the newspaper listings to get an accurate idea of how long it will take to rent your property and what you will get for it. A rental property will not bring in substantially more than the going rate just because it's brand spanking new. It may rent a bit quicker, but don't expect much more than the normal market will bear.

Now take your net cash flow. If it's negative, where will the money come from each month to make up the difference? Next, cut the net cash flow by 30 percent. Do this by cutting the income (Step 5) by 30 percent and recalculating net cash flow (Step 6). Now, can you afford it? Can you afford it for three years, five years? How about ten?

Negative Cash Flow

One thing needs to be made clear right now: Negative cash flow in real estate is not necessarily bad. Markets will change in time; they did in Long Island and Texas, and elsewhere in the United States. The question is, can *you* weather the storm? Can you handle negative cash flow for a prolonged period?

Roger and Betty handled their negative cash flow just fine. I knew they could, so I felt confident in encouraging them to invest in real estate at their season of money. No one knows when real estate will hit a peak or when it will rebound. The fact is, it doesn't matter as long as you have the cash flow to handle the long term. Roger and Betty did. In 2003, they sold the first investment house in Rocky Point for a $210,000 profit, plus the tax advantage they realized over the years. The second house in Middle Island is now worth about three and a half times their original cost, and after nearly eight years, cash flow just turned positive. Negative cash flow is not necessarily bad as long as you can handle it.

THE REAL ESTATE CYCLE

If a graph of real estate cycles were to be drawn up, it would look surprisingly like an economic or stock market cycle, except the time periods would be longer. Also, it is highly regional. Figure 11.1 might be somewhat representative of areas like Long Island or Southern California, but some areas will experience steeper and longer price swings. Any real estate investor should be prepared to ride out those swings.

In Figure 11.1, there is first a period of modest rising prices, typically about 3 to 4 percent or so per year. This period may go on for quite a few years and is typical of most average markets. In many parts of the country, it may go on for decades without significant change. Suddenly, you see an acceleration of prices due to demographic and economic factors. Hype starts to set in as we see wild price increases. Remember that real estate is *local*. Prices may jump dramatically in New York, remain steady in South Carolina, and drop in Tennessee. Sometimes, as happened recently in Long Island, California, and other areas, you see

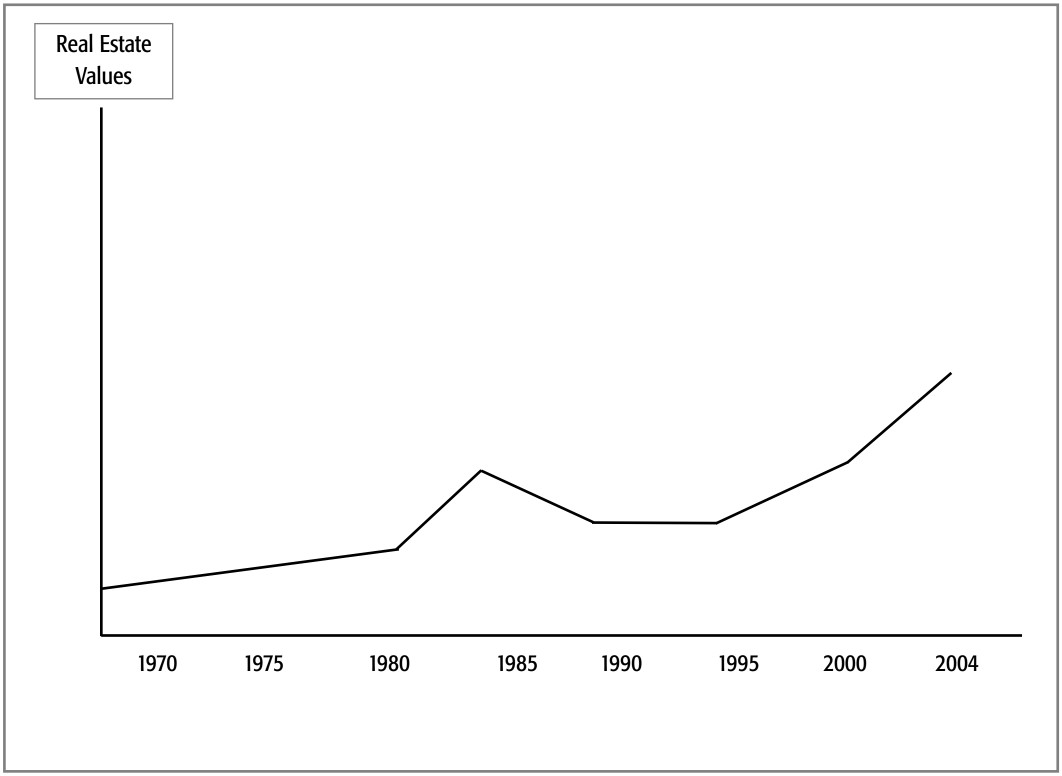


FIGURE 11.1 The Real Estate Cycle

an accelerated rise where prices will take off at 10, 15, or even 20 percent. This rapid acceleration will level off into a peak. The top may last a few years, or as in some communities, become pretty much permanent and be the base of another slow ascent. Very often, however, built-in excesses in prices bring about a generally slow downward spiral until the market "finds itself" at its base value price. Sometimes, local economic events can bring about a sharp downward curve. A major employer may close or the economy suffers downturns like Detroit in the 1980s, or areas of Texas in the 1970s, and bringing about a sharp decline in real estate prices. Potential individual real estate investors should be very aware of local economic factors that may affect their investments and be able to gauge in what part of the real estate cycle they are entering the market.

Location, Location, Location

Location is all. Yeah, I know, you've heard it before. Well, you're going to hear it again, because it's one of the absolute truisms of the small real estate investor. It holds true for large investors as well, but big corporations and wealthy conglomerates are better able to withstand errors than is the individual trying to reach financial independence.

What's truly important is not what real estate is doing nationally, but what it's doing in your own backyard—and what it's likely to do in both the near and distant future. Stay local, know your area, and be active. Don't ever be an absentee landlord unless you have a multimillion-dollar organization running large blocks of real estate. Know what's going on in your area, look for bargains and opportunities, and act when you're ready.

If you are investing in homes, always look for the small house, maybe rundown and in poor shape, but in a neighborhood more expensive than the home you're buying. Once you make the needed improvements, the property will grow in value because of its more expensive surroundings. Never buy the largest, most expensive home in a neighborhood. As an investment, it will lag in value when compared to similar properties in more affluent neighborhoods. Resist the urge for a quick buck in Uncle Harry's neighborhood four states away because he says it's bound to hit the ceiling. Stay in the area you know and understand. Location, location, location!

Four Kinds of Real Estate Investments

Active real estate investors will deal with four general types of investments:

BUY AND HOLD LAND FOR A PROFIT. This type of investment is usually the safest, but it's also the longest and holds the least potential for profit. It's the safest because land has negligible maintenance costs, very little property taxes, (it's when you improve it that the taxes jump), and unless you bought coastal property, swampland, or in an earthquake zones, very little can happen to damage it. Overall, it is probably the slowest growing type of property.

Of course, there's always the chance you may get in before a major event drives up the price of land in the area. That's difficult to anticipate and may never happen. Sure, you may have bought into the next Atlantic City or Orlando, but how do you know so far ahead of time that properties are still priced low? You don't, and by the time it becomes known, you won't be the only fish around. You will be competing for rapidly appreciating property; then the risk goes up. What if you pay a high price in anticipation of your property being in the forefront of the next economic boom and it turns out to be a dud? There are many people out there who bought land in Florida in the 1960s and 1970s in anticipation of major developments that went bust. Those properties are not worth much more than what they paid for them 30 or 40 years ago, if they can sell them at all. Stay local, watch the prices, and be aware of your area.

BUY LAND AND DEVELOP IT. Many fortunes have been made this way, but like any other investment, you've got to be careful. Study your market, and watch your cash flow. If you're going to put up a commercial building or shopping center, will the local area sustain it? Do you have tenants ready to rent and build sustainable businesses that will flourish, generating steadily increasing rental profits? In this case, I recommend hiring a firm to do a feasibility study to examine all the relevant factors for the success of your enterprise.

If it's residential, again many fortunes have been made and lost this way. Study your market and the supply and demand of new homes if you're planning to sell. Look at the supply and demand of tenants in the rental market if you're building apartments or homes to rent. Study the area. Do a careful cash flow analysis based on realistic, even somewhat pessimistic, expectations. Developing land is one of the most expensive and risky ways to invest in real estate, but if it's done right, it can also be one of the most rewarding.

BUY COMMERCIAL RENTAL PROPERTY. Shopping centers, strip malls, warehouses, and commercial buildings that will house viable businesses are great ways to participate in American business. Like any real estate investment, commercial property can also be risky, more risky, in fact, than residential real estate. In residential properties, unless you have grossly misjudged the market, you will usually be able to get tenants. The place may sit empty for a while, and you may get below what you anticipated, but people have to live somewhere. Your place will likely rent in good times and bad. Commercial properties, however, are not only more costly, but also are much more affected by business vagaries. In many parts of the country, strip malls have been boarded up because Wal-Mart, Home Depot, or Lowe's came into town and drove the small businesses out, leaving landlords holding the bag on empty stores.

Know the markets in your local area; understand the types of business you will be renting to and how they are affected by economic conditions. A law office, a doctor's office, an accounting practice, a deli, a pizza place, or a Chinese restaurant will hardly be affected by Wal-Mart and are less likely to go under during tough economic times. Again, know your area, stay local, and watch your cash flow—to the point of having a professional analysis done before signing on the dotted line.

Residential Rental Property. This is the most popular and probably the safest and most lucrative real estate investment for the individual seeking financial independence. Find that house in a good neighborhood, perhaps pay a little below market value, fix it up if it needs it, rent it, and maybe break even or at least not have too much negative cash flow. Who knows, maybe you'll even make a few bucks. Gain tax advantages along the way, sell it a few years later for a nice profit, and pay only a small amount in favorable capital gain taxes. It's an ideal scenario. If you have reached that stage in your financial season and your investment pyramid has reached that level, I recommend you go for it, providing you are ready to follow the cautious rules outlined below.

First, read the next section on being a landlord, and be sure you are mentally and emotionally ready for it. It can be quite challenging and tough on your psyche. Be sure you understand that and are ready to deal with it. Next, examine your cash flow. I know, I'm a broken record. Perhaps you are right, but I have been witness many times to the financial devastation of poor cash flow and unrealistic expectations. But take heart, when done right, active real estate investments will be the boost needed to get you financially independent and keep you there in the Age of Longevity.

Follow the basics, a small or average house in a good neighborhood, a bit rundown or even a lot rundown if it will bring the price down, is okay. Be sure to get an engineer's report to spot any potential major problems ahead of purchase. Also be sure to know the rental market locally so you can do an accurate cash flow analysis. Your main plan should be to keep the place rented, maybe make a few dollars or not put out too much monthly, while you gather the tax advantages. Eventually, your investment house will be worth considerably more than you paid for it. That's the ultimate reward.

On Being a Landlord

Like almost anything else worthwhile in life, it's not easy. There are certain specific rules I will give you in this chapter that you violate at your own risk. Following those rules does not guarantee success or even safety, but they will go a long way toward achieving your goal with the least risk. First, there's the basic temperament. It's a business; that's all it is. But it's a business that if not done right can threaten the financial well-being of your entire family and jeopardize your future.

You are morally and legally responsible for providing a good, safe, well-maintained rental unit in return for a fair rent. You are entitled to that rent morally and legally. Unfortunately, you may encounter tenants who have no morality and courts that are clearly not on your side. You may wind up with legal fees, damages to your property, and loss of several months rent before your deadbeat tenants are finally evicted. Get used to the idea, even plan for it. It could happen to you no matter how careful you are. It happened to me, so I'm speaking from experience. If you don't believe me, find an experienced landlord and talk to him or her. It will be an eye opener.

The first piece of advice I will give you is to be emotionally ready to look tenants in the eye and tell them that if the rent is not paid by a certain time, you will be evicting them, and be ready to make good on this threat. If you feel this is not something you can do, stop right there. Don't even think about buying residential rental properties, or commercial for that matter because business tenants will require the same handling. If you must go on to real estate investments, stick to land or find a trustworthy, crusty partner who can handle this unpleasant aspect of real estate.

If you have decided that you have the fortitude to handle evictions when needed, the idea is to do everything possible to avoid such unpleasant solutions. One of the ways to do this is by using a rigid selection system for your potential tenants. This is not discrimination. Denying people a home because of their race, ethnic background, religion, age, or other discriminatory practices is hideous as well as against the law. Individuals who plan to exclude certain people for these reasons should seriously examine what is in their hearts as well as the federal statutes.

It is perfectly legal and desirable to demand certain standards from tenants, standards that will make it likely they will have the means to pay rent and take care of your property. You can demand no smokers or no pets, if you feel it is desirable. You will have to balance the potential damage to your property against the value of tenants who would otherwise be ideal. That is a judgment each person should make. But what about the economic issues and the issue of general care of your property? The following three steps, while not a guarantee, will go a long way toward ensuring you have good tenants for many years.

1. Have an application for your prospective tenants to fill out. This application should have a section that authorizes you to perform a credit check on the applicant. Name and Social Security is all that should be required. It is illegal to ask any questions on gender, race, or any other areas that could lead to discrimination. Applicants must sign the authorization for you to check with TRW and other credit reporting companies. You cannot do so without their signed authorization. Refusal to sign this authorization gives you legal grounds for turning them down. After all, if they have a good credit record, why would they refuse this? One of the reasons is a series of judgments for not paying obligations like rent that will show up on a credit report. It's amazing how many landlords run into problems simply because the person "seemed so nice" and they never ran a credit check. Never accept an applicant without a credit report.

   You might encounter applicants who, except for a smudge on their credit reports, seem good in every way. Perhaps they made a mistake in the past, or maybe it was an error or even a consumer dispute where they refused to pay what they felt was an unjust bill. Be upfront. Ask them to explain it, and make your decision from there.
2. On your application, ask for employment details. What are their occupations, where do they work, how long have they been employed (if less than four or five years, who did they work for before that), what are their monthly earnings, and what are the prospects for continued employment? It is legal for you to ask these questions, and grounds for turning them down if they refuse to answer. Your application should also give you permission to call or write an employer to verify employment. If people are gainfully employed and earn enough to afford your property, there should be no reason for them to refuse. If they refuse, they are probably hiding something. Once you have the information and signed authorization, call the applicants' employers and verify the facts.
3. Get references from previous landlords. Go back to two or three previous landlords if possible. This is because a landlord having problems with a tenant may falsely give you a good report so the tenant leaves and becomes your problem. Again, the signed form should give you permission in writing to check references, and you should diligently check them. No amount of checking is foolproof, and sometimes bad things will happen to good people. But sticking to those three rules should go a long way toward preventing tenant problems.

USING LEVERAGE

One of the things that makes real estate so rewarding is the use of leverage. If you buy a $200,000 property for 5 percent down ($10,000) and the property goes up just 10 percent, you have made $20,000, which is not 10 percent but *200 percent* of the original cash invested. You can use leverage to dramatically increase your gains. Always try to buy with the least cash down possible. How little a down payment will vary with location and economic conditions as well as the general credit environment.

Always remember that leverage is a two-edged sword. In the above example, if your property goes down in value by just 10 percent, your loss on actual cash invested will not be 10 percent but *200 percent*. That's why it's so important not only to be wise and selective in your real estate investments, but also to be prepared to hang on if values decline, until they finally show a gain.

Progressive Plan of Action

At this point, you have accomplished the following:

- Made certain you have completed (or begun) the earlier sections of the Progressive Plan of Action.
- Developed basic knowledge of real estate investing and determined if you are psychologically ready for that next step. If you are, this is a good guide to start you off.

"A ship in a safe harbor is safe, but that is not what a ship is built for."

—WILLIAM SHEDD

CHAPTER 12

Risk Management

Risk management is a fancy term for what we used to call CYA, Cover Your Ass, in the army. For our purposes, it will be called Cover Your Assets! After working hard, using sound planning strategy, and following the advice in this book toward financial independence, it would be tragic to lose it all because some basic protections have not been taken. Unfortunately, I see this far too often—fortunes lost and futures ruined from lack of protection against the financial ravages of illness, old age, and liability.

For young people or those just starting out, it might be thought that liability protection is really not needed. After all, there's hardly anything accumulated. Well, think again. Remember the story of the 100 average Americans, how they worked and earned $1 to $2 million in

their lifetimes? That's what you could lose in tort liability lawsuits, your ability to earn income. If you are unprotected, and you wind up on the losing end of such a lawsuit, a good chunk of your future earnings will be garnished for years to come.

LIABILITY

Anytime you drive a car, own a home or business (even a one-person operation), operate a boat, bicycle, motorbike, snowmobile, or engage in the countless pursuits we all simply take for granted, you are running the risk of a liability lawsuit. Remember, you don't have to do anything wrong to get sued. The entire American legal system, which is created mostly by lawyer-legislators, encourages risk-free litigations on the part of both attorneys and individuals. No matter how ridiculous and lacking in merit the lawsuit, if an attorney can convince a jury an award is due, the attorney gets 35 percent and the client gets the balance. No one has risked anything but some time. This attitude pervades the country and is partially responsible for high insurance rates and enormous malpractice costs. Here are excerpts from a long running ad in Long Island, New York:

> *If you feel you have been hurt by a fall, a food, a product, an accident, you may be entitled to a large cash award. Call us, we're open 24 hours, we're open New Year's Eve at Midnight, the call is free, the consultation is free, call 1-800-LAWYERS.*

Got the idea? That's why being properly protected against liability lawsuits is so important.

BASIC PROPERTY PROTECTIONS

Insurance is regulated by the individual states so this can be only a general guide. You should consult with a knowledgeable property and casualty (P&C) agent in your state. Be sure you carry the maximum liability protection for your automobile, motorcycle, boat, snowmobile, ATV, tractor, or any other vehicle or piece of machinery of any kind that you will be owning or operating. Make certain you will be covered if someone uses the vehicle or machine; even if you have not authorized the use, you own it and may be liable. Ask about the various insurance quirks in your state. Is it a no-fault state, how about various things like uninsured driver? Make sure you have maximum protection for your home if someone falls or makes believe he or she fell. (Yeah, I know, I'm being cynical, but that's because I've actually seen this in action.) You should be protected to the extent that if a meteorite hits your car or house and a piece from the explosion strikes a pedestrian, you are covered! It's that serious.

Excess Liability Policies

Also called "Umbrella Policies," excess liability policies are one of the best insurance buys around. For a relatively modest premium, they will add millions in liability protection on top of your existing coverage. There are certain requirements that maximum liability coverage must be carried for your home and vehicles, which is a good idea anyway. Umbrella policies are sold in multiples of $1 million, and I would heartily recommend everyone have that amount at the very least.

INVESTMENT REAL ESTATE LIABILITY

This is covered in detail in Prosperity Point 5: How to Protect Yourself and Your Real Estate from Lawsuits.

BUSINESS LIABILITY

If you operate a business or are self-employed, you have a liability. Any kind of repair or service business or sales of products may leave you open for real or exaggerated lawsuits. The impact can be very real. I'm sure McDonald's restaurants felt it when they lost a lawsuit and had to shell out $1 million in that famous and ridiculous case where a woman spilled coffee on herself and sued the company for failing to warn her that the coffee would be hot. Perhaps high in the Himalayan mountain range in Tibet, there is a Sherpa who has lived in isolation inside a cave 22,000 feet above sea level, and has never come down, never listened to a radio or read a newspaper. Perhaps that person may be unaware that coffee in the United States is served hot. That's the kind of lawsuits you face.

The first recommendation is to consult a knowledgeable local attorney because again, it's regulated by the state. If you are in business or the trades, it is wise to operate as a corporation or LLC, following the advice of your attorney. Never have the corporation or LLC own very much, so if you lose a lawsuit, all you will lose may be a couple of thousand in the corporation accounts and a few odds and ends of low-value business property. Carry any needed insurance such as commercial liability, workers compensation if you have any employees, or other required insurance.

Certain professions such as medicine, physical therapy, and accounting are considered to be rendering personal services and as such cannot be shielded by a corporation. Incorporation may still be desirable in certain cases, for instance, if you have a physical therapy company and send out therapists for home services. One of your employees may be involved in an auto accident and you may be held liable because that person worked for you. Consult with your attorney for the best ways to protect yourself in your business.

HEALTH INSURANCE PROTECTION

Our country is in the midst of a health insurance crisis, and it's getting worse, with no answers in sight. I don't pretend to have any answers, and like everyone else, I struggle with this myself. My wife and I pay over $800 per month in New York for an HMO called MDNY. It's the only game in town. It's outrageous, but absolutely necessary. With today's elevated medical costs, one illness can wipe out a lifetime of hard-earned assets and destroy financial independence. If you have health insurance with your employer, great! Cherish that benefit. If not, you must have health insurance by hook or by crook. Make that a priority, and not just for the financial protection. There is no doubt that good health insurance can mean life or death in the quality or promptness of care received.

If you are over 65 and have participated in the Social Security system, you are now eligible for Medicare, the federal health insurance program for people over 65. First, contact your Social Security office if you are not already in the program. Second, purchase a good medigap policy in your state. Medicare has a 20 percent deductible, which can be quite onerous financially. After all, illnesses costing $1 million or more are not unusual, and 20 percent of $1 million is $200,000. In New York, a good medigap policy costs between $1,200 and $1,800 per year. Consult with a medical insurance expert in your state.

Long-Term Care

Long-term care insurance? In a word, yes! It is something everyone over the age of 50 should have. Lack of long-term care insurance can be the greatest single danger to passing accumulated wealth to following generations and can also affect the remainder of your years. Long-term care is covered in Chapter 13 in the section on basic estate planning.

LIFE INSURANCE

Life insurance was covered in detail in Chapter 9, and it should already be in your plan. If for some reason, you have not covered this yet, I urge you to review this chapter and follow the recommendations.

Progressive Plan of Action

At this point, you have accomplished the following:

- Made certain you have completed (or begun) the earlier sections of the Progressive Plan of Action.
- Understood and reviewed risks for personal liability in home ownership, invested real estate, and any vehicles you own, including boats and recreational use vehicles.
- Understood and reviewed all risks in professional and business liability, if appropriate.
- Understood and reviewed health and long-term care risks.

"Whoever's in the house when I die, gets it!" —BILL COSBY

CHAPTER

13

Estate Planning

Estate planning is like cutting the lawn or taking out the garbage. It's one of those mildly unpleasant things that tends to be put off, but when finally done, gives a sense of relief. Whew! Got that out of the way! Except that putting off estate planning can have much more serious consequences than smelly garbage or overgrown lawns.

The actual process of estate planning is not unpleasant in itself. It's just that you must think about subjects you would rather not deal with: injuries, illness, and death. As you will see in this chapter, the consequences of not planning your estate can be very bad for the loved ones you leave behind. Estate planning should never be put off, because you never know when your last moment will come.

BASIC ESTATE PLANNING

Four basic documents everyone should have: A durable power of attorney, a health care proxy, a living will, and a last will and testament. I don't care if you're worth $100 million or $100, everyone should have these documents. It's about much more than money; it's about softening the emotional impact of illness on your family and avoiding placing burdens on those you love. It's about protecting yourself against needless suffering and controlling your destiny. And, yes, it's also about money.

The four must-have documents are:

1. Durable power of attorney
2. Health care proxy
3. Living will
4. Last will and testament

Durable Power of Attorney

This document allows another person, designated by you, to act as your "attorney in fact," that is, to handle financial and other nonmedical affairs in the event you are legally incompetent. "Incompetent" is a term used to describe a medical condition—sometimes temporary, sometimes permanent—that prevents you from understanding what is going on and completing everyday tasks like writing a check or signing your name. Accidents, strokes, and various illnesses are the usual causes of incompetence. With this instrument, the person you have designated can access your accounts, sign documents on your behalf, pay your bills, and perform other needed tasks.

Naturally, the person you choose should be someone you trust completely: a child, a sibling or another loving and trusted person. The chosen person should also have common sense and an understanding of what they must do. The person must be trusted to act intelligently on your behalf. Usually husbands and wives will designate each other, but there must always be a successor designated in the event both spouses are incapacitated. Don't make the mistake of thinking that because you are married and own everything jointly, you don't need this. There are many financial instruments you cannot own jointly, retirement plans, for instance. If one spouse is stricken and the other spouse needs to access funds from the stricken spouse's IRA, the healthy spouse will not be able to get this access because IRAs and retirement plans can only be held in one name. Another instance is signing for a real estate closing. A couple may have a house in contract, and if one spouse is stricken, the other spouse may use the durable power of attorney to sign for the stricken spouse.

Note that in cases of second marriage where assets are reserved for one side instead of a spouse, there may be a need for someone other than a spouse to hold the power of attorney. Consult with a competent attorney for such issues.

If there is no durable power of attorney in place, your spouse or family must hire attorneys to petition a surrogate court to get that power of attorney. It's expensive, time consuming, and emotionally draining on spouses and families already burdened by the impact of your condition. Having this simple instrument drawn up provides an inexpensive solution. Be aware of the difference between a regular power of attorney (POA) and a durable power of attorney. A regular POA cannot be used when the person who granted the POA becomes incompetent. A durable POA may not be used if a person is *not* incapacitated. It is only valid in case of incompetence, and medical proof is usually required to activate it. Some states allow a combination of these two types of POA, sometimes called a "jumping" POA.

Health Care Proxy

This legal document permits someone else to make medical decisions for a person when that person is incapacitated, incapable of making such decisions. The health care proxy may be the same person who holds the durable power of attorney, or it may be someone else. In either case, the person named should be able to exercise good judgment in the face of the emotional trauma and make sound medical decisions on behalf of the individual. Very often spouses will designate each other as health care proxy. A health care proxy document only allows medical decisions, and a durable power of attorney allows all others to be made on behalf of the person, but no medical decisions. This is why both documents are needed. Failure to have a health care proxy in place may mean medical decisions would be made by a hospital committee instead of a trusted relative or friend who understands your wishes.

Living Will

This document addresses a person's final days. It answers the question, of when all hope is gone, when death is inevitable, and perhaps only a day or so away, do you want to be hooked up to machines and kept going for an additional week or two? Most people would answer no. Quality of life would be nonexistent, perhaps painful, and to what end? It certainly won't make relatives feel better to drag out death a few more days through the use of machines. The living will spells out your wishes when the end arrives. It specifically states what may or may not be done. Usually the language in a living will requires that everything be done to make the last hours comfortable and as pain-free as possible. Feeding, hydration, comfort, and pain control may be demanded whereas heroic measures (machines) that can artificially prolong life for a few days or weeks are prohibited. Consult with your doctor for what should be allowed and specifically articulated in your living will. Without a living will, a hospital committee will usually elect to keep you artificially living a bit longer; they are often duty bound to do this simply because you have failed to express your wishes through a living will.

In 1995, Long Island *Newsday* carried a heart-wrenching story. There was a photo of an older gentleman in a courtroom crying. He was pleading with the court to let his wife, a well-known former Clairol model, die with dignity. She was in a coma, dying, but kept alive by machines in a Nassau County hospital. She had not executed a living will even though she had expressed her wishes often to her husband. The court finally allowed her to die naturally after almost a month of emotional trauma for her family and, who knows, possibly great suffering on her part.

I want to make an important point at this time. Many readers may be in their 20s or 30s and feel they are too young to worry about such things. Everyone should have this document drawn up, so there is no question. The classic case for a living will often studied is that of Karen Ann Quinlan. She was 20 years old when she lapsed into an irreversible coma from a reaction to a combination of drugs. She lingered on for several years until the courts finally allowed the removal of the machines that had been keeping her artificially alive. There was never any hope. She was brain dead and simply a shell holding organs made to function by machines.

In more recent times, specifically March and April of 2005, there was the unfolding tragedy of Terry Schiavo. Her case touched nerves globally, and caused gut wrenching reactions here in the United States involving all three branches of the federal government. Her family, which at one point may have had good relations, has been torn apart by animosity. Nothing in the world could have restored Terry Schiavo's health and many questions would still have gone unanswered. However, if her final wishes fhad been expressed by means of a living will, much agony would have been avoided. Over half a million dollars would have gone for her care and legacy instead of paying lawyers. The lesson is clear: Everyone should have a living will.

During the last couple of months, as her case played out in the media, my office received scores of calls regarding living wills. Then our dear pope died and his passing pushed the Schiavo case off the media's attention and already the calls are waning. Don't you make that mistake, get a living will.

Last Will and Testament

Known as the "Will," this instrument directs the disposition of a person's estate after the person dies. In a sense, everyone has a will whether they had one made or not. When a person does not have a will and dies, that is called dying "intestate." The states have specific laws that govern the distribution of the estate. So everyone has a will after all. It's just a matter of deciding whether you will direct the disposition of your estate to those you want or let the state do it according to how legislators believe your estate should be distributed. The choice is pretty clear. Everyone should have a will drawn up to carry out their last wishes.

A will can handle much more than just who gets what. It can also spell out *how* it is received. For example, a well-loved, but irresponsible adult child or relative may receive an inheritance by means of a trust in which a responsible trustee is appointed to make sure the funds are not squandered. Trusts may be created by the will, a "testamentary trust," or during the person's lifetime, an "inter-vivo" trust. Trusts are also either *revocable*, which means the grantor can revoke it, or *irrevocable,* which as the name implies, cannot be changed even by the grantor. Always consult with a competent attorney before setting up trusts.

In addition to trusts, a will can name guardians for children and specify certain properties that a person wishes to remain in the family. An executor (male) or executrix (female) is named to handle the disposition of the decedent's property according to the decedent's wishes, and a probate court supervises the whole thing. A will is actually a very complex instrument, even the so called simple wills, and should only be drafted by a competent attorney within the state of residence.

In 1995, I decided to incorporate my practice. I'm not an attorney, but I know a lot of business law. Because I can act as my own attorney, I decided to do it myself. I got the papers from Staples and some additional documents from a legal program, filled it all in, and sent it to the New York State Department of State in Albany, New York. It promptly came back rejected. There had been some changes in the law, and some different language was required. I redid it, and it came back again. I finally got it right on the third try. Now here's a question for everyone: How many tries will you have at those four must-have documents described above? One, just one. And you had better get it right! Here is my specific recommendation: get a competent attorney in your state to draft those four documents. Don't try to save a couple of bucks by doing it yourself. My wife and I both have those documents, and they were prepared and executed by our attorney.

The above documents are regulated according to the laws of the individual states. Many states have provisions for blending these documents into one, for instance, a health care proxy may be included with a living will or a durable POA. The states regulate this, and rules differ among states. If you move to another state, you may have to have these instruments redone. Immediately check with a local attorney in that state.

Probate

There are a lot of myths circulating about probate, so let's try to clear some of them up right now. Probate is simply a court-supervised distribution of an estate according to the directives set in a decedent's will. For modest estates in New York, this goes relatively easily and usually can be done by the executor without an attorney. Larger estates and special situations will require advanced estate planning strategies.

It is beyond the scope of this book to provide a guide for advanced estate planning. The area of advanced estate planning is so complex that a specific guide may not be possible. It may wind up being just an encyclopedia of potential strategies and available estate planning tools. I believe that for a sizable and complex estate situation, professional help should be sought. There are many competent planning attorneys, tax accountants, financial planners, insurance agents and others who specialize in this field. As in working with any professional, be sure to check credentials and records before hiring.

A source I would recommend is Sandy F. Kraemer's, *The 60 Minute Estate Planner* (Prentice Hall, 1999). It's an easy-to-read common sense guide to estate planning and is updated every few years. It will give you some ideas on what's involved in estate planning, and help you determine if you need an advanced estate plan as well as provide suggestions on choosing the right professionals to carry it out.

LONG-TERM CARE

Long-term care is the need to provide help for individuals who are unable to perform what is known as the activities of daily living (ADL). These are the things we take for granted each day, the things we don't even think about. For purposes of determining who is eligible and needs long-term care, there are five activities defined:

1. Bathing
2. Eating
3. Transfering (moving around) and dressing
4. Toileting
5. Taking medications

Ronald Reagan and Christopher Reeve are two famous people who needed such help. Both of these well-known and well-loved figures passed away in 2003 and 2004, respectively. Christopher Reeve is an example of the unexpected and tragic pitfalls of life. But while his story is inspiring as an example of courage and the indomitable human spirit, it is former president Ronald Reagan's story that you should pay particular attention to.

Reeve's tragedy is not something average people will face. Reagan's story, however, illustrates what many of us, baby boomers or not, will face as longevity increases. When you look at the five ADLs above, it doesn't take any stretch of the imagination to see that losing any two will mean an individual will require care on a continuing basis. And it is something many of us will face as we age. Reagan's condition was particularly bad because of Alzheimer's disease, but many folks will develop conditions such as strokes, diabetes, and other debilitating diseases or just fall victim to plain weakness and frailty due to old age.

What Is the Cost of Long-Term Care, and Who Pays for It?

Long-term care is very expensive, and without taking steps to protect themselves, people may find their entire life savings wiped out in a few short years, or find themselves living miserable lives because of the financial inability to take care of themselves. Many people will encounter sad situations where instead of leaving a legacy behind, their children and grandchildren will be burdened by the financial cost and emotional impact of paying for their long-term care. See Figure 13.1.

Figure 13.1 and 13.2 give average long-term care rates throughout the country, although they may not be accurate for your region. For example, in Long Island,

Care	Cost
Adult day care	$45 per day (8 hours)
Meals-on-wheels	$52 week (10 meals)
Unskilled home care	$8 to $16 per hour (Skilled care rates are much higher.)
Assisted living facility	$900 to $3,000 per month
Nursing home	$160 per day ($58,400 per year)

Source: Center for Medicare and Medicaid Services and the Agency for Healthcare Research and Quality, November 2001, data for 2001.

FIGURE 13.1 Costs Associated with Long-Term Care

Age Group	One Disability	One or More Severe Disability
15–65	18.7%	8.7%
66–79	52.5%	33.4%
Over 79	71.5%	53.5%

Source: Administration on Aging, U.S. Department of Health and Human Services, *Current Population Reports*, "American with Disabilities," August 1997.

FIGURE 13.2 Americans with Disabilities

New York, the figures are almost exactly double. Figure 13.2 shows that as people age, they are ever more likely to need care.

There are only three sources of payments for long-term care costs:

1. *Out of pocket*. Expenses paid by individuals for their care from income, savings, and investments. Wealthy persons will be able to afford the cost, but people of moderate wealth who had hoped to leave substantial amounts to kids and grandkids may see their legacy depleted. I have been witness to this a number of times because people had simply not prepared.
2. *Government resources*. I want to tell you that this one is disappearing faster than the dodos! Medicaid is the program that provides this service to people in need, but they must be destitute, usually owning less then $3,000 in assets. If they have assets, they will be required to liquidate them to pay for their care until they are down to less than $3,000 (approximately, it varies by state). This is knows as the "Medicaid spend-down." How about if you give all of your assets to the kids when you get sick and need long-term care? The Omnibus Budget Reconciliation Act of 1993 (OBRA '93) provides that transfers within three or five years to a trust will delay or eliminate benefits, forcing a recapture of the amounts transferred. Other provisions of OBRA '93 allow the states to recover from the person's estate all payments made by Medicaid. Medicaid is basically medical welfare for people who have no insurance and no money, and it is funded in part by the states and in part by the federal government. With the tremendous budget deficits and numerous tax cuts since 9/11, Medicaid funding is entering a crisis. Even after qualifying for Medicaid, people will see cutbacks and lower quality services. It's an inevitable trend that can only get worse as the population ages and increased longevity becomes more common.
3. *Long-term care insurance*. Right now, this is the best solution, and I recommend anyone over the age of 50 to seriously consider purchasing a policy as soon as possible. I am 58 and my wife is 57. We both have long-term care policies to take care of ourselves and preserve our estate. A nationally known financial author recommends that people wait until age 65 to buy a policy because even though the premiums will be higher, the returns if premiums were invested from age 50 to 65 would make up for the higher cost. This is true but poor logic and risky because she omits a most important factor: Long-term care insurance is medically underwritten. That means a person who develops diabetes, heart conditions, severe arthritis, strokes, or any of the ailments that plague as we age, may not be eligible at 65. It's a roll of the dice I would rather not take. I stand on my advice: get a long-term care policy when you reach age 50.

The perfect policy does not exist. Many features and companies must be compared and weighed, and naturally, the more benefits, the higher the premium. I recommend professional guidance from an independent specialist in such areas, a professional who will research the market and present several companies so the best policy for your situation can be chosen. Some of the leading companies, as of 2004, providing quality long-term care policies are John Hancock, GE Capital, 1st United American, Prudential, Transamerica, Massachusetts Mutual, and Metropolitan Life. There are many more.

Progressive Plan of Action

At this point, you have accomplished the following:

- Made certain you have completed (or begun) the earlier sections of the Progressive Plan of Action.
- Put in place the four must-have basic estate planning documents for you and your family.
- Examined your estate planning situation to determine if advanced planning is needed and, if so, begun the process.
- Considered the implications of long-term care if you are over 50, and purchased a long-term care policy suitable for your situation if you have not already done so.

"The hardest thing to understand is the income tax." —Albert Einstein

CHAPTER 14

Income Taxes

There are two things in life you should never watch too closely as they are being made. The first is sausages, and the second is tax laws. The reason you don't want to watch them while they are created, is because they are so incredibly messy. Tax laws are the result of a political process, and the word "politics" tells you all you need to know: "Poli" comes from the Greek, and it means "many." "Tics" well you know what they are, little blood-sucking insects.

The government starts out with good intentions, to achieve desirable social goals and fund the business of the nation by using the tax system. Corporations and businesses get tax breaks so they can create jobs, and pump up the economy; charities get tax deductible donations for

good works; supposedly the rich get taxed more because they can afford it, and every special interest group has congressional lobbyists to promote favorable tax treatments for whoever hired them. The whole thing works reasonably well, except it is horribly convoluted, terribly complex, sometimes unfair, and constantly changing.

Most people would rather have their fingernails pulled out than deal with taxes. Yet, taxes are an essential fact of financial life and demand attention. They permeate every money transaction. To ignore taxation is to risk having substantially less wealth. Benjamin Franklin once said in his *Poor Richard's Almanac*: "A penny saved is a penny earned." Consider this:

- Paying taxes never created wealth for anyone.
- A dollar saved on taxes, is a dollar that can be invested.
- A dollar invested will grow to many dollars with time, and will help make you financially independent that much faster.

The J.K. Lasser 2004 Professional Edition for tax preparers contains 991 pages. It's well beyond the scope of this book to give a specific guide for everyone with a myriad of tax situations. This chapter will help to set a frame of mind, and give you basic information on the U.S. tax system so you will be able to work effectively with your tax advisor.

One thing to keep in mind with the income tax system is that it's semi-voluntary. It's semi-voluntary in the sense that it's complicated, and the government will not tell you what strategy to use or which loophole would be more favorable for you. Take an easy example: Suppose you own a home, pay property taxes and mortgage interest, and donate money to your house of worship. You are entitled to deduct all those things by itemizing expenses, that is filing a form called a Schedule A for your Form 1040, and that will greatly reduce your taxes. But you don't have to. You can file a Form 1040A, don't itemize, use the lower standard deduction and pay a lot more taxes. You will not get a note from the IRS telling you to file that Schedule A. That is not its job and in effect, you will have "volunteered to pay more taxes."

TAXES AND LUMP SUM EVENT (LSE)

An LSE is a financial situation, such as an inherited IRA or dealing with a 401(k) when changing jobs, where a person must handle a large sum of money. If you are facing one of those events, then you have reached a defining moment in your financial life. You stand at a crossroad of decisions, and how you handle it might be the difference between early and prosperous retirement, or continued working into old age. Perhaps no other financial event is more influenced by taxes then having to handle large sums of money. The most common LSEs are the source of the largest headaches and where people make the biggest mistakes. Chances are, that in your lifetime, you will face at least one or more of these. Here are the top four events and the most common mistakes:

1. I*nherited IRAs or retirement plans*. The biggest error is taking all the money at once. It's all taxable income, and when added to your regular income will no doubt propel you in to the highest brackets. In some cases, when state taxes are considered, you could lose as much as 40 percent of the total. There are new IRS rules that will allow you to take the distribution over the course of your lifetime, resulting in lower taxes. But certain elections must be made within a specific period of time. Don't accept the money until you have discussed the situation with a competent tax advisor.
2. *Rolling over a company retirement plan when leaving your job*. Again, the biggest error is just taking the money all at once. Now you have the added 10 percent penalty if you are under age 59½ and you could lose half the amount through taxation. Another common error is rolling the money over on your own, but failing to meet the 60-day time period. The best bet is a direct transfer to another financial company IRA so the funds don't actually pass through your hands. That way, there's no chance of error.
3. *Borrowing from a 401(k) and failing to repay it*. The biggest error people make is not knowing the actual costs involved and/or being unable to repay the loan. Sometimes the costs are deducted from your 401(k) and it is more than you would have paid if you borrowed money elsewhere. Other plans will have very favorable terms and even allow the interest to be paid in your account. There are good plans and bad ones; be sure you understand yours before borrowing. In any event, not repaying the loan is considered a premature distribution and will have the same impact as cashing it in: A tax bill that may be as high as 50 percent of the funds involved. Get all the plan documentation and consult with your tax advisor before borrowing from your 401(k). There may be better options.
4. *Cashing in annuities and other financial instruments*. The biggest error anyone can make is cashing the darn thing in without looking at the tax impact, or exploring other alternatives. When an annuity is cashed in, the built-in gain is immediately taxable as ordinary income. If you've had the annuity for a decade, and during that period it has earned a certain amount accumulated inside the annuity, it will all be taxable at once when you cash it in. The same thing applies on certain treasury bonds that accumulate interest. When you cash them in, all the interest is taxable at once. Sometimes there are ways to avoid this. An annuity can be exchanged using IRS Section 1035

as a tax-free exchange for another, perhaps better annuity. Treasury bonds may be cashed in gradually over a number of years to soften the tax impact. Of course, individual needs will always come first. If you absolutely need that lump sum, then you have to do what you have to do. Just be aware of the tax impact, consult with your advisor and perhaps you may discover a better way to handle the money.

IRS UPDATE

Do you remember the original *Godfather* movie? Remember how it started out at the wedding of Don Vito Corleone's daughter? Do you remember Luca Brazzi, the fearsome enforcer for Don Corleone who kept practicing his mumbled congratulations to the Don? Well, think of Congress as Don Corleone and Luca Brazzi as the IRS. Congress makes the tax laws and the IRS enforces them. It's important to know how the IRS works and what has been going on there lately.

A little over a decade ago, a new commissioner was appointed and tasked with re-organizing the IRS. That suited the incoming commissioner. He wasn't a career tax person anyway. His specialty was re-organization. Re-organizing the IRS is like turning over the world's biggest anthill: lots of scurrying and confusion. Around the same time, congressional hearings exposed some abuses by rogue IRS agents and certain practices, that although legal, were definitely unsavory. Stung by the criticism on one side, and congressional mandates to cut back expenses on the other, IRS audits during the 1990s dwindled until they reached record low rates, below 1 percent. That was a dumb government move, sort of like a department store trying to cut expenses by removing the cash registers and security cameras.

Surveys and studies in 2002 and 2003 revealed some trends that alarmed authorities. Record numbers of Americans thought is was okay to cheat on their taxes, and believed the likelihood of being caught was very low. Indeed it was. I recall several occasions in the 1990s when I advised clients against certain deductions and other items on their tax returns because of the risk of being audited. I was amazed when they did it anyway and were never caught. Well, things have changed. In 2004, my firm handled a record number of audits, and in addition, two IRS initiatives came into full bloom: Market segment and lifestyle audits.

Market segment took nearly a decade to develop and is aimed at the business community. Before market segment, an IRS auditor would audit, say a dental office one day, the next it might be a hardware store, and the following a restaurant. Now auditors are trained in specific "segments" of the business market. Auditors only handle their specialties, so an agent auditing a restaurant knows that industry inside and out, resulting in much tougher audits.

Lifestyle audits are aimed at prosperous members of the underground economy as well as snaring those who profit from illegal enterprises. It's kind of simple really. Suppose you live in an expensive gated community, your house is luxurious and expensive, complete with inground swimming pool, three-car garage with a Jaguar and a Mercedez in two bays, and an expensive speedboat in the third bay. You must be very good at budgeting and saving, because according to your tax return, you manage to do all this on $18,500 per year! Because of the lifestyle audits, you may be asked to explain how you paid for all this, and where the money came from. There may be a good explanation, such as money from an inheritance. But if there isn't, and you have been massively cheating on your taxes, be careful, because you're heading toward a train wreck.

In addition to these two initiatives, a new commissioner was appointed when, and he is a career IRS tax person. He has vowed to turn the audit and compliance rate around and has taken vigorous action toward that goal. Especially targeted are the self-employed, business owners, and people who use certain large deductions.

Of special value to all is Prosperity Point 11: How to Audit Proof Your Tax Return and Prosperity Point 12: Specific Ways to Save Money on Your Income Taxes found in Chapter 15. Read them carefully to protect yourself against audits, and to save money on income taxes. Here's a crucial piece of advice: Add any money you save on taxes to your 10 Percent Plus Solution. Your key to financial independence will be that constant build-up and investing of funds that normally would have been lost because of lack of money awareness, not setting and reaching for financial goals, or paying too much in income taxes.

Progressive Plan of Action

At this point, you have accomplished the following:

- Made certain you have completed (or begun) the earlier sections of the Progressive Plan of Action.
- Became conscious of your income tax situation. Reviewed Prosperity Points 11 and 12, and applied any savings realized to your 10 Percent Plus Solution.

PART II

Prosperity Points for Financial Security

"Many people take no care of their money till they come to the end of it."

—JOHANN VON GOETHE

CHAPTER 15

Prosperity Points

Prosperity points are a compilation of my latest cutting-edge financial and tax strategies. Although not all of these ideas are appropriate for everyone's situation, certainly some of them will apply and provide a boost toward financial freedom. Each strategy has been implemented and audit tested, but tax laws and economic conditions change. Stay in touch with www.prosperousboomer.com for any updates before pursuing these methods.

The advice in just one of these points alone can save you much more than the price of this book. Review them often. The time for certain ideas may not be right at the moment, but opportunities in your life can present themselves suddenly, and then one of those points may provide significant savings.

PROSPERITY POINT 1: ***How to Get Out of Debt in Five Years or Less***

The following advice will absolutely get you out of debt, and in most cases, it will do it in five years or less. But it's only about 25 percent of the total strategy, the final culmination of a process that will bring you to financial independence.

There are three key factors that will ensure your success and leave you debt free. Like anything else in life that is worthwhile, it will require your will, discipline, desire to be debt free, and eventually financially independent. The good news is that it's not difficult, won't take up a lot of your time, and in the long run, will significantly improve the quality of your life by eliminating the stress, anxiety, and worry that comes from carrying burdens of debt.

The first step accounts for 75 percent of the results you need to become debt free. Go back to Chapter 3 and reread the sections on money awareness and the 10 Percent Plus Solution. Read it. Study it. Practice it. I guarantee it will change your life.

Once you have started money awareness, you begin practicing the 10 Percent Plus Solution. This will put a certain monthly amount of money in your hands. This money is your *Freedom Factor*. Once you have your Freedom Factor, take the steps outlined below.

Step 1

Set aside two places for your debt-elimination project. The first one should be where you will keep all your bills and other records of debt. This can be a file in a file cabinet, a drawer, cardboard accordion folder, or plastic box. It should be separate from other records. Only debt records should go in that file.

The second place is on one sheet of paper, which should be put where you see it often, where every day you can note your progress and maintain the motivation to stay the course. Perhaps you can put it above your make-up or shaving mirror, on the door to your closet, or on the refrigerator door. Look at it daily, and track it constantly. It's your key to freedom in the Age of Longevity.

Step 2

Prepare your freedom sheet. This is a simple listing of your debts in reverse order of monthly payment size, starting with the smallest monthly payment. It will look like Figure P1.1. This is the sheet you will display for yourself and update as you eliminate debt.

Step 3

Your first target is the one with the lowest monthly payment. In this case it would be the Discover card with a $24 monthly minimum. Now we take the Freedom

FIGURE P1.1 Freedom Sheet I

Debt	Balance Owed	Monthly Payment	Interest Percentage
Discover	$1,250	24	9%
Mastercard	$2,540	45	6%
Visa	$6,370	60	8%
Car loan	$12,850	620	4.5%
Home equity line	$9,500	510	7.2%
Total debt	$32,510		

Factor, the amount of monthly cash obtained from using money awareness and the 10 Percent Plus Solution, and add it to the normal monthly payment that would be made on the Discover card. Let's suppose that we have been able to free up $250 per month. (The exact amount is not as important as the fact that it is *something* and that you are continuously striving to increase it.)

Our freedom factor amount of $250 is added to the minimum as a principal payment. The total becomes our Accelerated Payment 1, in this case the total payment to Discover is now $274 monthly. This will eliminate the Discover card debt in about five months or less. Your debt sheet will then look like Figure P1.2.

FIGURE P1.2 Freedom Sheet II

Debt	Balance Owed	Monthly Payment	Interest Percentage
Discover	0	0	9%
Mastercard	$2,540	45	6%
Visa	$6,370	60	8%
Car loan	$12,850	620	4.5%
Home equity line	$9,500	510	7.2%
Total debt:	$31,260		
Accelerated payment 1:	$274 for 8 months		

Step 4

You are now to be congratulated. You have reached that all-important milestone, you have permanently eliminated one debt. It may be a small amount, but it's a crucial psychological first step to freedom. One of the reasons why this system works so well, is because it's like a barbed fish hook. You can always increase your 10 Percent Plus payments added into the *accelerated payment*, but like the fish hook, you should never pull it out. Let the lure of your upcoming financial freedom be the "barb" that prevents you from backing out of your charted course to elimination of debt.

Now tackle the next debt with the lowest minimum monthly payment, and add your previous accelerated payment 1. In this example, it was $274 added to the Mastercard minimum of $45 you have been paying. You now have your accelerated payment 2 in the amount of $319. Continue paying this down until it is liquidated, in this case about eight months. Your debt sheet will now look Figure P1.3.

Continue this way until you have built a substantial monthly accelerated payment. At that point, start targeting debt selectively. Begin with the ones that are not tax deductible and have the highest rate of interest. When you are done with those, begin with the ones that are tax deductible, such as business loans or home equity lines. Leave the mortgage off for now, and when you have everything else paid off, consider the mortgage buster plan, Prosperity Point 2.

Follow this method scrupulously, combined with money awareness and the 10 Percent Plus Solution. They are proven and powerful methods to reach financial independence.

FIGURE P1.3 Freedom Sheet III

Debt	Balance Owed	Monthly Payment	Interest Percentage
Discover	0	0	9%
Mastercard	0	0	6%
Visa	$6,370	60	8%
Car loan	$12,850	620	4.5%
Home equity line	$9,500	510	7.2%
Total debt:	$28,720		
Accelerated payment 2:	$319		

For those of you who would like this system in a more refined computer tracking system, I recommend ordering DebtFree™ for Windows, which is debt-elimination software that will perform and track calculations and more, while staying on track to debt elimination. Order it by calling (888) DEBTFREE.

PROSPERITY POINT 2: *The Mortgage Buster*

How to pay off a mortgage while keeping the tax advantages.

As a person's discretionary income increases, there are a number of choices available for the wise use of that extra income. One question that often comes up is whether the mortgage should be paid down or even paid completely. On the one hand, there are the tax advantages and the fact that mortgage rates are lower than other forms of credit. There is also the flexibility of having the cash build up instead of vanishing into paying down a mortgage. On the other hand, that monthly payment is a financial drag. Here's a solution that gives you the best of both worlds.

Instead of paying down the mortgage, invest the amount into a fixed annuity with flexible payout options that can be activated in the future. By flexible, I mean that once the annuity builds to a target amount, it can be turned into a payment stream targeted as a specific monthly income amount for a specific number of years. The amount targeted will be matched to the mortgage so when the goal is reached, the annuity payments will be sent directly to the mortgage company. In effect, the annuity will be paying the mortgage so you won't have to.

While the annuity is paying the mortgage, you retain the tax advantage of both the annuity and the mortgage. Figure P2.1 shows how it works.

FIGURE P2.1 30-Year Mortgage Chart

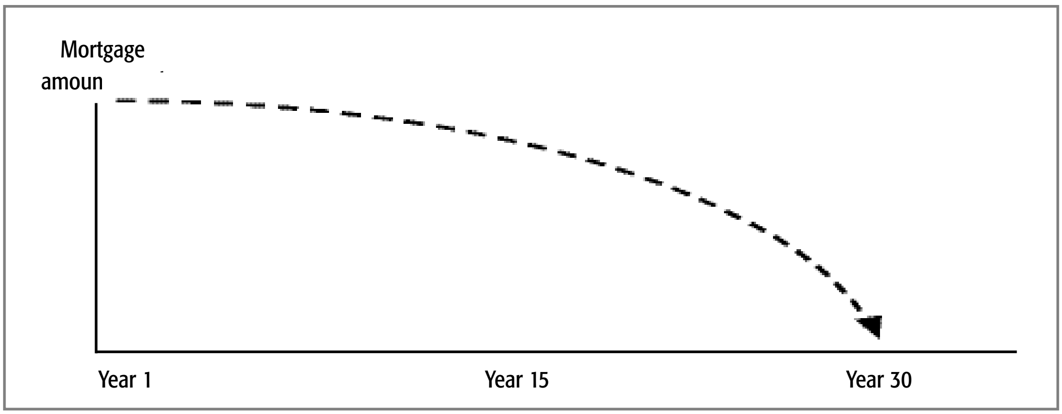


FIGURE P2.2 Mortgage Buster Cash Buildup

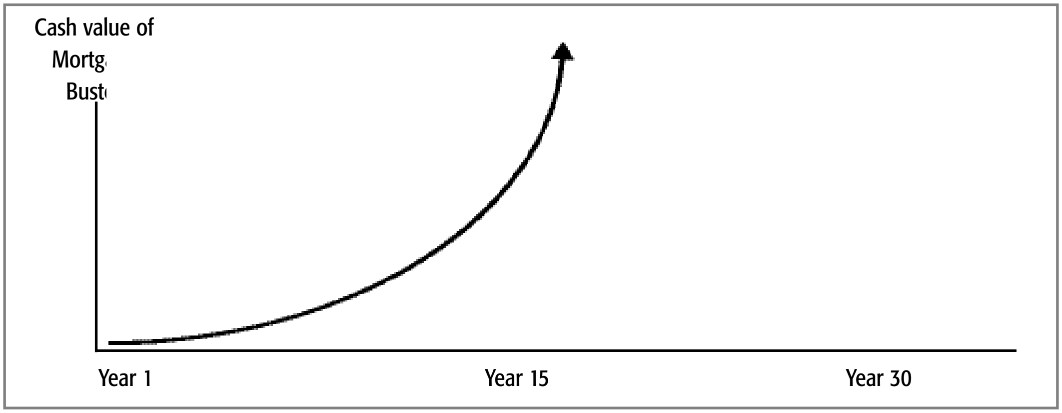


Figure P2.1 is a visual depiction of a standard 30-year mortgage. Because the interest in mortgages is front-loaded, principal payments are relatively low during the early years. As principal is paid down, interest decreases and principal payments increase until the mortgage is paid off on the 30th year.

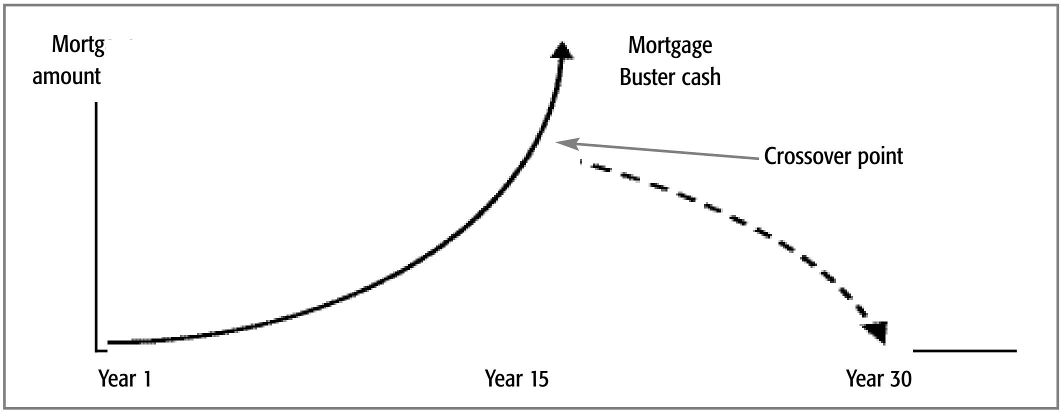
The mortgage buster, Figure P2.2, works in the opposite direction from a mortgage. Cash builds up slowly as you contribute monthly amounts. The speed of the buildup depends on your budget and the amount from your 10 Percent Plus Solution. As time passes, the cash value builds up rapidly from what Albert Einstein called "the eighth wonder of the world," compound interest.

As the cash builds up in the mortgage buster annuity, it will reach a point where the payout options can be exercised to take over the payments for the remaining life of the mortgage. (See Figure P2.3.) In effect, you keep the tax deductions, pay a small amount of taxes on the funds used out of the annuity that year as the payments are being made for you. Your mortgage is effectively "busted," yet you keep the benefits.

Another great benefit of this system is the flexibility. You control the annuity, and in later years you may continue to pay the mortgage while building up the annuity for a great source of future income. In the last two or three years, I have had a number of clients who retired, sold their houses at a profit, and paid off the mortgages with the proceeds of the sale. The mortgage buster was then turned into another source of income to enrich their retirement. This kind of flexibility is just what you need to live a prosperous nonlinear life in the Age of Longevity.

The tax advantages are what makes the mortgage buster work so well. The annuity grows with no taxes during the cash buildup period.

FIGURE P2.3 30-Year Mortgage Chart with Mortgage Buster



Annuity interest rate:	4% (Farmers and Traders Life, October 2004)
Mortgage holder's tax rate:	25% federal plus 5% New York State
Net after tax rate of return:	5.71%
Mortgage interest rate:	5.5%
Net after tax interest:	3.85%

The Exclusion Ratio

You will discover this tax advantage when the mortgage buster reaches a value where it can placed in payout mode, called *annuitization*. The annuity will now send a monthly check to pay the mortgage, and you will be taxed only for the amount dispersed, and then only in proportion to the untaxed buildup in the entire annuity. For example:

> *Annuity X has reached a point where it will pay $1,200 a month for ten years. The original contributions into the annuity add up to 71 percent of the total value, and the remaining 29 percent is untaxed interest "build up." Each $1,200 payment will be taxable for 29 percent of the amount, or $348. This is not the tax to be paid, just the amount of taxable income. In a tax bracket of 30 percent, the tax would amount to $104.*

Recommendations for Mortgage Buster Annuities

I recommend a fixed annuity for the mortgage buster investment because the principal is guaranteed and the interest rates are competitive. A mortgage is guaranteed because you are guaranteed to pay it, so it would be wise to use an equally guaranteed and fixed product.

My favorite is Farmers and Traders Life (F&T) in Syracuse, New York, (877) 2FT-LIFE (238-5433) because of its unique and flexible means of annuitization by means of its Supplementary Contracts. The exclusion ratio applies, but payments are not locked in for longer than a year. I love this flexibility, and it has come in handy many times. Aside from its own financial strength and stability as a mid-size mutual company, it is domiciled in New York, a state that offers the greatest protection for annuity and life insurance consumers. See Prosperity Point 4. If your state is one of the approximately 25 states F&T Life operates in, I would strongly recommend this company for your mortgage buster.

Other recommended fixed annuity providers for the mortgage buster are:

- AIG
- Allianz
- Hartford Life
- Union Central
- John Hancock
- Prudential

There are many more fine companies; the ones mentioned here are just some of the best. For some other things you should be aware of when investing in a fixed annuity, read Prosperity Point 6: Split-Funded Annuities.

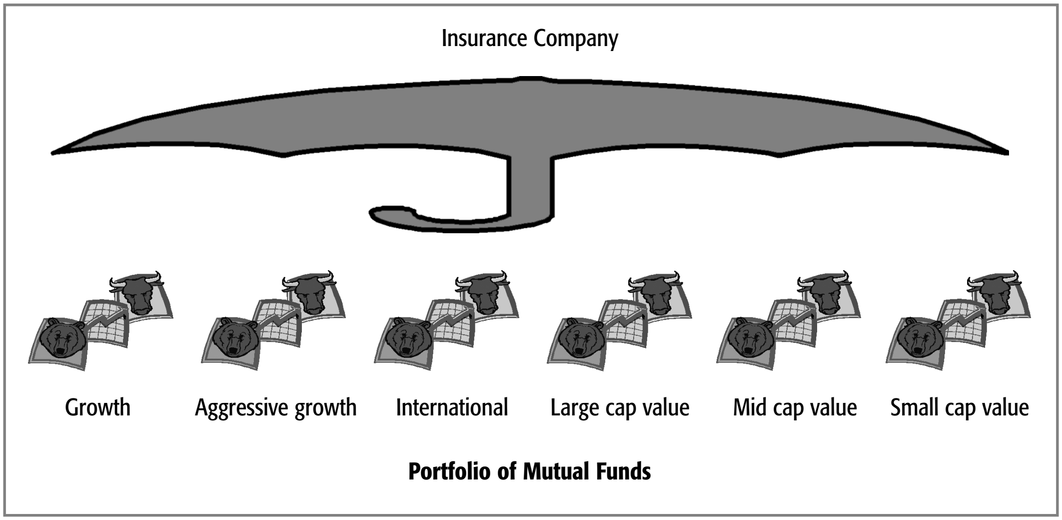
PROSPERITY POINT 3: *The Lowdown on Variable Annuities*

A variable annuity is simply mutual funds under the umbrella of life insurance. See Figure P3.1. Variable annuities are *not* life insurance; they simply carry some small elements of life insurance. If the markets drop and the value of your variable annuity takes a nose dive and if you die during this period, the variable annuity will pay your beneficiaries the highest amount it reached or your original investment, depending on the product and company. Proceeds will also pass to heirs immediately, outside of probate.

Variable annuities were originally developed in a time of high taxes, when capital gains and dividends were taxed at ordinary rates or at most discounted to 28 percent instead of 31 or 36 percent. Dividends issued by mutual funds were also taxed at those same high rates. It made sense during those years to defer taxation until you were older and retired, and presumably in a lower tax bracket.

It certainly made a lot of sense to the insurance companies who were now able to cash in on the growing popularity of mutual funds. These annuities were very

FIGURE P3.1 Variable Annuities



profitable for the insurance companies because they realized about 1 percent per year in various charges while the owners took the risks and responsibilities for rates of returns.

Variable annuities cost the consumer on average about 3 percent per year. The insurance companies keep about 1.5 to 2 percent of the cost.

Now here's the big secret the insurance companies hope you never find out: because of recent tax law changes, variable annuities will *cost you more in taxes* than mutual funds, roughly twice as much! It's really not a secret, of course; anyone who understands and follows tax laws will tell you the same thing. The insurance industry is keeping quiet because it doesn't want its cash cow wandering off.

Taxes and Variable Annuities

Until 1978, the highest federal income tax rate was 70 percent, applied to taxable incomes over $200,000. A series of legislative actions brought the top rate down to 39.6 percent. Then recent tax legislation, Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), took the top rate down to 35 percent in 2004 for people with taxable incomes over $319,000. For people with more average taxable incomes ranging from $30,000 to $70,000, the tax rate is 25 percent. Over $70,000, the rate is 28 percent until it reaches $146,750, when it is 33 percent.

One might think that it's still worth it to use a variable annuity if you're in the 25 percent or above income tax bracket. The sales pitch is that you pay no taxes, thereby saving a great deal until you reach retirement age. You are then in a lower tax bracket and have a higher standard deduction for being over age 65.

Insurance companies push these annuities because of their returns. If you have one of these annuities, you might say, "Wait a minute, I only saw a policy charge of $35 taken out, not 1 or 2 percent, what gives?"

Read the prospectus. The fees are built into the sub-accounts, which are mirror duplicates of the mutual funds they are managed by. Let's say you have a good year in the market. You look at your annuity values and calculate you made about 9 percent. Great, but you actually made about 12 percent; the annuity fees gobbled up the extra 3 percent. It takes a lot of analysis and digging to figure it out. In a bad year, if you see your policy go down by 6 percent, well the actual loss was only 3 percent; the balance was the fees that are taken out in good years or bad.

The argument goes, so what? You pay 3 percent, but save 25 to 28 percent for the average person and if you live in tax states, you save on average 5 percent more. So it's worth it to spend 3 percent to save a combined total of 33 percent.

It used to be. But it's not only the overall *rate* of taxation that has changed; it's also the taxation for certain *types* of income. The result is that variable annuities will *cost more* in taxes for most people than mutual funds.

For mutual funds taxation is:

Qualified dividends:	15% (Most dividends are qualified.)
Capital gains	15%

This applies for long-term capital gains over one year issued by the funds or shares sold if held over one year. Most mutual fund investors hold their funds over a year, so the average tax paid will be about 15 percent—or less if in a lower income tax bracket.

Any money removed from a variable annuity is taxed at *ordinary income rate*. *Capital gains and qualified dividends rates do not apply!* For the average income earner, that means you have just converted from something taxed at 15 percent to something taxed at 25 percent. On average, you will be paying 13 percentage points *more*. The argument about being older and in a lower tax bracket doesn't hold water. If you're in the 10 or 15 percent tax brackets, capital gains will be taxed at 10 percent.

And it gets worse. If you have mutual funds with gains and some funds or other properties with large losses, you can write off the entire amount of the losses against the gains in your mutual funds if you sell them in the same year. A $12,000 capital loss can be written off against a $12,000 gain on the sale of a mutual fund. If you sell a variable annuity with gains, it is considered ordinary income. You can only write off $3,000 of capital losses because they are considered passive losses.

Here's another kicker: If you take money out of a variable annuity when you're under age 60 and not disabled, you will be taxed an additional 10 percent (2003 Form 1040, page 2, line 57). No such penalties exist on the sale of mutual fund shares.

Conclusion

I am not making a blanket statement that no one should ever use variable annuities any more. What I am saying is that you should not use taxes as a reason to buy them because in actuality, you (or your heirs) will wind paying more income taxes than you would had you invested in pure mutual funds. The insurance companies and their agents will *never* tell you this, anymore then your Ford dealer will tell you to go buy a Buick. There are still reasons to use variable annuities. But those reasons will not apply to everyone and must be balanced against the potentially greater tax liability.

Some of the reasons to buy a variable annuity are:

- An unusual and particularly effective basket of varied mutual funds would be difficult and cumbersome to put together without them being included in one annuity. The normal fees and load of many of these advisor-sold funds are not applied within the annuity and may result in lower costs.
- The step-up guarantee of the annuity in case of death. Variable annuities guarantee that if you die, your heirs will receive at the very least the amount you invested. Many annuities now have a provision for paying out the highest amount the annuity reached. This means if you have an annuity for your kids or grandkids, you are fully protected against stock market losses.
- Mutual funds and other assets, if not held jointly or through a trust, will be subject to probate and possible challenges to the will. This is especially significant in divorces and second marriages. Annuity proceeds pass directly to beneficiaries by operation of law and generally cannot be challenged.
- Recognizing that they faced loss of sales from changing tax laws, many annuity providers put in place desirable features: guaranteed income at future dates no matter how the funds performed, and/or bonus amounts from 3 to 7 percent immediately added to the value of the investment. Of course, nothing is life is free, but I have found the cost is usually worth the benefit. Each potential cost and features should be examined carefully before buying.
- Many states include variable annuities for credit and bankruptcy protection whereas mutual funds could be vulnerable against legal action. Check with

an attorney in your state if this is one of the reasons you are contemplating a variable annuity.

Anyone contemplating a variable annuity should never buy it on tax-saving hype. Be aware that it will probably cost you or your heir more taxes than if you had invested in mutual funds. Balance the above reasons against the tax consequences to reach a sensible decision.

Specific Recommendations

Variable annuities are regulated by the states. There are thousands of providers, and their products often differ from state to state. A comprehensive list would be too cumbersome, but here are four of my favorites. It doesn't mean that a product not on this list is not good. These are just the ones I know. If you are contemplating a variable annuity that is not listed, compare the cost and features of the product you are considering against the product and features of the ones listed.

Obtained from advisors:

- Manulife/John Hancock Venture Annuity
- 1st Sunamerica Life Polaris Annuity
- American Skandia
- Prudential

For do-it-yourselfers, the following both have low-cost variable annuities:

- Vanguard Funds
- Fidelity Investments

PROSPERITY POINT 4: *How to Get the Protection of the Most Consumer-Friendly Insurance State*

New York state offers more protection for buyers of life insurance, annuities, and long-term care policies than any other state. The New York State Department of Insurance controls a well-maintained fund supplied by mandatory contributions from New York state insurance companies. This fund is designed to protect consumers in the event of an insurance company going out of business. In addition, state regulations toward insurance companies are so tough that many insurance companies form wholly owned subsidiaries so the entire company does not have to meet the stringent requirements of New York. Thus, there is AMEX Insurance Company in all states except New York, where it is AMEX Assurance Company. It is U.S. Life and U.S. Life of New York; Manulife and Manulife of New York; and so on with hundreds of others.

This protection was deeply appreciated by holders of life insurance and annuities about a dozen years ago when Executive Life Insurance went bankrupt. In every state where Executive Life operated, policy owners found themselves without life insurance or with large portions of the cash values in the annuities and life insurance policies they held also lost. In New York, the New York State Department of Insurance stepped in and rescued the policy owners by using the insurance fund and coercing the large New York companies such as Metropolitan, Prudential, and New York Life into taking over the failed policies of NY State Executive Life.

For this reason, when working with clients and insurance products, I always insist that they use only New York state insurance companies, and that everything is signed in New York state. Strangely enough, you do not have to be a resident of New York state, only have the annuity or life insurance application signed and witnessed in New York state. The only proof required is the insurance agent's signature on the application and the New York address where the application is signed. On most applications it's just a city, county, and New York state.

You may get a slightly higher rate of interest somewhere else, but I can tell you that it will not be significant enough to forego the protection of the New York Department of Insurance. I would also rather have an A– or even B rated company in New York, then an AA rated company elsewhere. I recommend staying with at least A– companies in New York state, there are plenty to fill everyone's needs. Outside of New York state stick with AA or at least A+)

PROSPERITY POINT 5: ***How to Protect Yourself and Your Real Estate from Lawsuits***

First and most important, be sure you have proper insurance on your building or land so you are protected to the maximum companies allow for liability. Next, be sure you have an excess liability policy as recommended in Chapter 12: Risk Management. These strategies, although very effective, are not a substitute for having the right insurance. They are designed to protect you if you lose a ridiculously high lawsuit, surpassing the highest amount of insurance available.

Active real estate owners are in a high lawsuit-risk investment. The properties are often rented to multiple tenants, yet the owner is responsible for any injuries or wrongs caused on their properties. Injuries to tenants or their guests resulting from fights, arguments, parties, falls, or conditions on the property will often cause the owners to be held responsible simply because they are the owners. "Injured" parties driven by lawyers hungry for the 35 percent contingency fee will always go after the property owner with the perceived deep pockets, rather than the tenant with little money or resources. Without strategies to protect themselves from liability, property owners could lose not only their property, but also other properties and personal assets, including large chunks of future income. Here's how to protect yourself.

1. Put a wall between yourself and personal liability by using a corporation or LLC (limited liability company) to hold the property. The property will owned by and titled to the corporation or LLC, which you control by being the shareholder. Liability cannot penetrate through the corporation to you. Other assets and future income will be safe.
2. Everything the corporation owns, however, will be at risk. So if the corporation holds a building with net equity of $300,000, this equity will be lost if the corporation is held liable for that amount. In order to minimize the risk, the property should always be mortgaged for the highest amount possible. When the property increases in value, it should be remortgaged or have a second mortgage. That way the equity at risk is always minimal. The mortgage should be secured by the property, and the cash obtained from the mortgage should never be owned by the corporation. Use the cash obtained to open an instrument to pay mortgage payments as they are due. A good example would be the mortgage buster (Prosperity Point 2).

Be warned, using a corporation or LLC is not a cover for insufficient insurance or unsafe conditions. There are many precedents in which the corporate veil was pierced because it was deemed to be a subterfuge to avoid maintenance or insurance. Also, because the laws vary widely among states, consult with a competent local attorney for incorporations, LLCs, and details on these strategies.

PROSPERITY POINT 6: *Split-Funded Annuities*

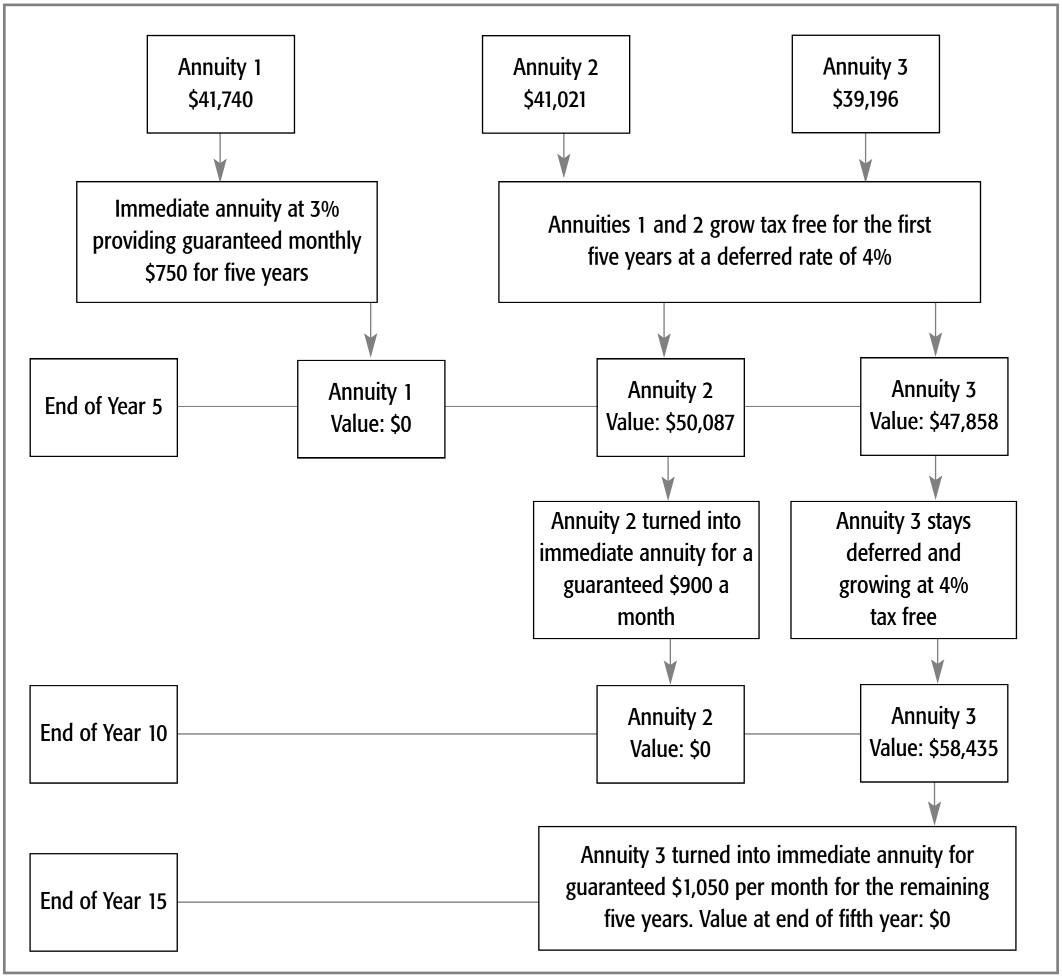
In previous chapters, you saw the importance of steady sources of reliable, guaranteed income and how income instruments should be separated from growth investments. Dependable, steady income is crucial to a long and prosperous retirement. You can't enjoy the nonlinear life in the Age of Longevity without the monthly check. A great strategy for providing this income is to use accumulated assets to set up split-funded annuities. If assets are not sufficient at this time, continue to accumulate into mutual funds that may be sold at a later date to set up the income investments. Another alternative is to invest directly into the annuities until they reach the amounts needed.

Here is how split-funded annuities work. Suppose you determine you will need income for 15 years, and you want that income to increase by 20 percent every five years to handle inflation. Let's suppose the income you need to start out with is $750 per month. Here are the payments you will need:

Years 1 through 5:	$750 per month
Years 5 through 10:	$900 per month
Years 10 through 15:	$1,050 per month

In this scenario, you will need a total of $121,957. It seems like a lot until you realize you are demanding guaranteed payments that increase by 20 percent every five years, pay you a total of $162,000 over that time, are secured, and profit from the tax advantage. Figure P6.1 shows the split-funded technique.

FIGURE P6.1 Split-Funded Annuities



The total amount collected was $162,000 from an investment of $121,957. Payments and principal were guaranteed, and overall taxation was minimal.

Approximate taxable income per year for years 1 through 5:	$652
Approximate taxable income per year for years 5 through 10:	$2,596
Approximate taxable income per year for years 10 through 15:	$4,761

This example is based on the unusually low interest rates prevailing in 2004. I believe rates will return to more normal levels in coming years. Outside of the immediate annuity where rates are guaranteed for the payout term, the interest rate may change. However, the companies usually guarantee a competitive rate for a number of years ranging from one to five, and sometimes longer.

Be aware that certain companies have been promoting "bonus" annuities that have boosted the initial rate well beyond normal levels. Some of these bonuses are as high as 3 percent, and many buyers of annuities are lured into purchases by the big interest rate and the word *guarantee*. Read the fine print. These guarantees usually expire after one year, and you will receive a much lower renewal rate at that time. The renewal rate will often be well below normal rates, and there will be large penalties for cashing the annuity in before periods ranging from six to ten years! Nothing in life is free. The best you can hope for is a fair deal. No one will give you 7 percent when prevailing rates are 4 percent. Don't be fooled. Demand the record of renewal rates for that company and the minimum guaranteed rate.

I recommend the following companies for fixed annuities to use in a split-funded income strategy. There are many more companies not listed here. Whenever you consider a fixed annuity, be sure that it is at least A.M. Best rated at A or above, A– is acceptable in New York state, but nowhere else. Also be sure to check the rate history, penalties, and schedules available when turning them into payout-immediate annuities.

Farmers and Traders Life, Syracuse, New York, is one of my favorites because of its supplementary contract that allows payout of any chosen monthly amount for just one year. The flexibility to change the monthly amount of income every 12 months while keeping the tax advantage is a great benefit that none of the other companies seem to have. This company seems to have a better handle on tax issues than the others, probably because two of its vice presidents were former IRS tax attorneys. Some other good companies include:

- AIG
- 1ST Sunamerica Life
- Allianz
- Harford Life
- Union Central

- ING
- TIA
- John Hancock
- Integrity Life

PROSPERITY POINT 7: *Private Annuity Trusts*

How to Reduce Capital Gains on Investment Real Estate

A private annuity trust (PAT) is a way to reduce capital gains. Suppose you own some real estate that has appreciated quite nicely. You're tempted to sell it and take the gain because the tax rate on such gain is only 15 percent. This is true, but there are a number of other factors that might make the tax bite higher. Depreciation has to be recaptured and could be taxed as high as 25 percent. In addition, state taxes may add another 7 percent (in New York) to the total. In addition, and seldom mentioned, is the boost to your adjusted gross income (AGI). Even if the majority of the gain is limited to 15 percent plus state tax, your tax bill may be considerably higher because of the higher tax bracket for other income and the loss of itemized deductions, exemptions, and other tax breaks only available at a lower AGI. In light of the amount of appreciation of real estate in recent years, gains may be substantial, and your actual tax rate may be more in the area of 25 to 30 percent rather than a straight 15 percent.

The PAT may be a solution if you can take a tax-advantaged income stream instead of a large lump sum, or if you want to pass substantial portions of the gain with reduced taxation to family members. Credit is due to National Association of Financial and Estate Planning (NAFEP) for developing this sophisticated tax strategy.

1. Have your attorney prepare a private annuity trust. This will be your own intrafamily trust controlled by your family. Your heirs and other family members may be beneficiaries to the trust. Be careful. Because of tax laws, the trustee, the person who controls the trust, may not be you or your wife. You may have another trusted family member or an advisor such as an accountant or attorney named as trustee. Be cautious about your choice because the trustee will hold a certain amount of control over the trust.
2. Assuming you have a ready buyer waiting in the wings, you sell the property to the trust and have it enter into a private annuity agreement with you, resulting in an installment sale. The advantage is that you can choose the amount of income payment and resulting reduced taxation. A $300,000 capital gain may be stretched out to 5, 10, 20, or 30 years or more, diluting the

taxation to small annual amounts. You will report this income on Form 6252 of your Form 1040 as an installment sale. There will be two components: the interest charged, because in effect you are getting paid in installments, and the percentage of capital gain applied to the total amount received. This could be done with a private buyer, but then you have the problem of the buyer not paying you in the future. This way you are guaranteed payment because the PAT is controlled by your family through the trustee.

3. The trust (PAT) now sells the property to that buyer waiting in the wings. The buyer takes out a mortgage or pays cash, and the PAT receives the cash. Because the PAT bought the property from you and sold it right away at the same price, it has not realized a capital gain and will not pay taxes.
4. The PAT now buys an annuity that names you as the annuitant and pays you and/or your spouse the income you want. There are infinite varieties to the amount and structure depending on your wishes and needs. The final result is tax savings. The greater the gain, the greater the PAT savings.

This strategy should not be applied to primary home sales. If you lived in the house two out of the last four years, you may take $500,000 tax free gain for a couple, or $250,000 for an individual. Unless you have a really huge amount of gain, well above half a million, you're better off taking that clean tax break.

I recommend working with professional advisors, Enrolled Agents (EA), Certified Public Accountants (CPA), and attorneys to put together this strategy. For an annuity product, the Farmers and Traders Life annuity lends itself very well to this strategy because that unique supplementary contract annuity payout can be changed each year.

PROSPERITY POINT 8: *Section 1031 Exchanges*

How to Defer Capital Gains on Real Estate Sales

Section 1031 of the Internal Revenue Code allows the tax-free exchange of like-kind property used as an investment and/or in a business. If you own highly appreciated business real estate (commercial or residential rental properties), want to exchange the property for another property you feel may do better in the future, *and* don't need the cash from the sale, then a Section 1031 exchange of like-kind property may be right for you.

You can have a "deferred" exchange in which you immediately transfer exchanged property and later receive like-kind property or a "reverse" exchange in which you receive exchanged property before you transfer the property you are exchanging. In either case, the properties must be placed in trust using an attorney or title company. If you receive payment first, it will be treated as a sale.

The time limit set by the IRS to complete the transfer is 180 days, but the properties must be *identified* within 45 days. In fact, that's the difficulty in using this strategy.

For this to work and be accepted by the IRS, you must have a buyer at the price you want for the property you are selling and have found an exchange property with a willing seller at the price you want to pay. All this has to be done within 45 days, with the properties specifically identified. The exchange must then be closed within 180 days.

If you manage to get through the logistics, you have exchanged properties, and taxation is deferred. Your cost basis from the old property will be carried through to the new one, and reported on Form 8824. Unless you are an EA, CPA, or tax attorney, I advise getting professional help to implement this strategy. It is definitely not a do-it-yourself thing.

PROSPERITY POINT 9: *Section 1035 Exchanges*

How to Take All the Money You Paid on Your Term Life Insurance and Deduct It from Future Earnings on Investments

There are only two things that can happen to term life insurance: either you die or the policy dies. After the term of the policy has passed, there's no cash, and you don't get your money back because you didn't die.

Well, they are wrong. If you understand the semi-voluntary system of income taxes, there's a creative way to get this money back through a little-known and seldom-used tax advantage. The reason it's little-known and seldom-used is because of the separation of certain areas of financial services. CPAs understand this strategy once they look at the relevant sections of the Internal Revenue Code. However, because it involves insurance, they don't usually deal with it and don't really understand insurance. Insurance agents are not trained for, nor do they want to handle, the complexity of the code. So no one puts this together. I happen to be masochistic enough to handle both issues, and with the help of an insurance company have developed this audit-tested strategy for recouping money spent on term life insurance.

In Prosperity Point 8, you saw how Section 1031 allows tax-free exchange of like-kind properties. By delving deeper into the code, you come upon Section 1035, which handles the tax-free exchanges of annuities and life insurance. This section was designed so policies could be exchanged without recognizing taxation, and you can use a nifty little loophole in that section.

Section 1035 specifically states what type of policies may be exchanged and what they may be exchanged for. This is because certain policies like life insurance,

FIGURE P9.1 Policies that Are Allowed to be Exchanged Tax-Free

From	To Life Insurance	To Endowment Contract	To Annuity
Life insurance	Yes	Yes	Yes
Endowment contract	No	Yes	Yes
Annuity	No	No	Yes

have tax advantages that annuities do not have, primarily the availability of tax-free loans and tax-free death benefits. Annuities do not have these tax advantages, so Section 1035 does not allow the exchange of annuities to life insurance.

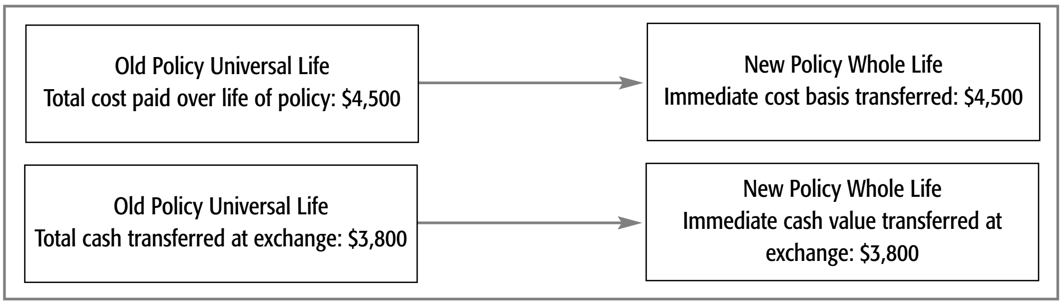
As Figure P9.1 shows, life insurance, which carries the greatest advantage, is allowed to be exchanged for either an endowment contract or an annuity. (An endowment contract is a form of life insurance that has lost certain tax benefits.)

The loophole is that Section 1035 does not limit or specify what kind of life insurance policy may be exchanged. Outside of endowment contracts, it does not exclude any kind of life insurance policy, including term.

Here is what is exchanged in a Section 1035 exchange:

- *Old policy cost basis*. This is the amount of money you have paid into the policy over the entire time you have had it. It is the total cost of the life insurance premiums you have paid over the years. This cost will now become the new cost basis of the new policy. If you pay into the new policy after the exchange, it will be added to the cost basis transferred.
- *Old policy cash values*. Whatever cash has accumulated into the old policy is transferred into the new one.

FIGURE P9.2 A Typical Section 1035 Exchange

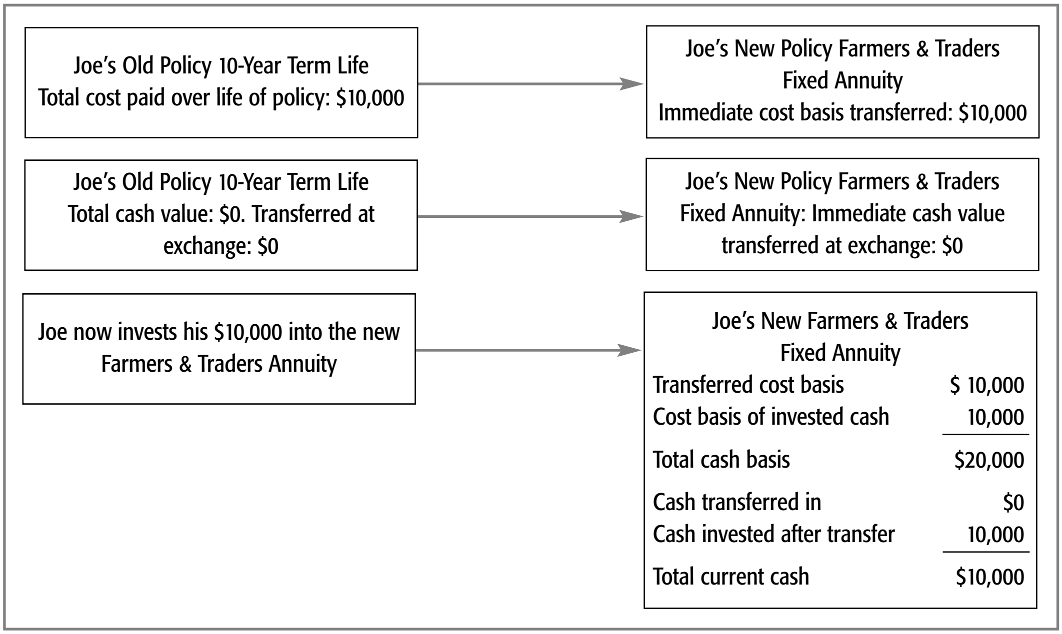


The key factor here is that Section 1035 makes no correlation between cost basis and cash values. This means you could have a policy with a high cost basis and little cash value, which is often the case in many life insurance policies. Sometimes because of poor performance and penalties, the cash values may be nothing. Conversely, the cost basis could be high, as in the case of a poorly managed variable life insurance policy in which money has been invested and lost. In other words, cost basis could be high, and cash value could be as low as zero. And cash value could be high, and cost basis could be low.

What you are going to do is exchange a term life insurance policy for an annuity as Figure P9.2 illustrates. It is not prohibited, although I'm sure this is not what anyone had in mind when Section 1035 was written.

For example, Joe owns a $500,000 face value term life policy on his life. He has owned the policy for ten years and paid premiums of $1,000 per year, each year. Joe's policy expires at the end of the year, and he no longer needs this insurance. Joe also has $10,000 to invest, but because he is in a high tax bracket, tax advantages are important to Joe. Rather than let Joe's term policy die out, it is exchanged for an annuity. He gets back all the premiums he spent as a tax advantage against the earnings he will get when the $10,000 is invested. Figure P9.3 indicates how it will work.

FIGURE P9.3 Joe's Term Life Insurance Section 1035 Exchange



Annuities earnings are taxed as ordinary income when taken out of the annuity. However, only the previously *untaxed gains* are subject to taxation. The cost basis, the original amount invested, is not taxed because it is a return of principal. By transferring the term life insurance into the annuity, Joe has added the cost basis of the expiring term life to the new annuity. Joe can now double his money over time and take out the profit tax free up to a total of $20,000. In effect, he has taken all that he has paid on his old term life insurance and applied it against earnings on investments.

Technical Notes

The term policy must be in force. A policy that has lapsed has ceased to exist and cannot be exchanged.

I wish I could tell you to contact any insurance company or their agents and this could be done for you, but unfortunately, that is not so. Insurance companies do not understand this procedure and are usually baffled. It's ironic that they are the ones constantly touting the tax savings of annuities and life insurance, yet they are often clueless. As of this writing, I only have one insurance company that will accept Section 1035 exchanges of life insurance into one of their annuities—Farmers & Traders Life Insurance of Syracuse, New York, (877) 238-5433. As mentioned earlier, it has two vice presidents who are former tax attorneys with the IRS, and they truly understand both life insurance and tax issues.

Over the years I have contacted all the major life insurance companies as well as a few small ones. The usual response was "You can't do that." When I faxed them the relevant copy of the Internal Revenue Code that specifically states you *can* do that, they responded that they were not interested anyway. For the longest time I didn't understand this attitude. Then a vice president of one of the largest insurance companies in the United States explained it to me. He said:

> *Look, I contacted our legal department and our tax specialists examined it, and yes, you're right. This can be done, but we are not going to allow it because none of our agents will understand it or handle it. If we started doing this, it would be just for you, and it's not worth it to change our procedures for one person.*

My thoughts were that it would be more than just one person. It would be a tax advantage for their clients, but they didn't see it that way. So F&T Life is the only company that will currently do this. If I find any others, I will notify subscribers of the web site.

The other difficulty that will be encountered is getting the information from the term life company that you are exchanging into the F&T Annuity. In order to effect the exchange, the term company must send a letter to F & T Life informing them of the cost basis pre-TEFRA and post-TEFRA. (TEFRA is a tax act that changed the taxation of life insurance, so cost basis must be separated pre- and post-TEFRA.) The companies are simply baffled. It will take several letters and phone calls before they understand what is needed. F&T Life has been helpful in facilitating such transfers. (It should be, after all it is getting funds into its annuities.)

PROSPERITY POINT 10: *Tax Credits*

How to Take Money Out of an IRA Tax Free or Stop Paying Estimated Taxes

Which is better, a tax deduction or a tax credit? If you answered credit, reach around and give yourself a pat on the back. You've got some tax savvy, so you'll appreciate this even more. A *deduction* is deducted from taxable income while a *tax credit* is a dollar-for-dollar offset of a tax liability. If a person is in the 25 percent tax bracket, a $100 deduction is worth $25, but a credit is worth the full $100.

One of the ways in which the federal government tries to alleviate the high cost of housing and homelessness is through the Federal Housing Tax Credit Program. This program provides a tax credit for individuals investing in low-income housing. However, most individual investors do not have the means to fund such projects, but they can pool their resources through the use of partnerships funding those projects. Boston Capital is a company that specializes in financing low-income housing throughout the nation. Here is a basic explanation of how the process works:

An investor in a high-tax bracket purchases shares of a fund for a specific project or series of projects and receives 10 percent of the value of the original investment each year for ten years in the form of federal tax credits. After ten years, the properties are sold and the investors get more or less than they originally invested. The kicker here is that even if they make no profits and just break even, they will have realized a 100 percent gain because of the tax credits. The investment is in a series of properties, usually garden apartments, occupied by low-income seniors. Like any real estate investment, there are risks. You could lose money. However, the risks are softened by the tax credits that amount to an up-front refund of money invested.

Because this is a tax-driven program, you must be in a high tax bracket for it to be effective. The higher the tax bracket, the more effective it is. Boston Capital will not accept any investors who have incomes below $35,000 per year and a net worth below $35,000. (Even that income is rather low. I would recommend a minimum income of $50,000 and up before considering this.) When I work with clients on tax credits, I first analyze their tax situation to be certain this program will be effective. Then I make sure they understand the risks and the lack of liquidity. (It's a ten-year investment.) Then the clients are turned over to a specialist who will again drill them on the risks and how the program works before finding the most suitable series for them to purchase.

Here's how this ties in to IRAs and paying estimated taxes. Suppose you wanted to draw down your IRAs by a certain amount each year and the distributions from the IRA would result in $1,000 additional income taxes each year. By investing $10,000 in a tax credit program, $1,000 of annual tax credits would be generated that would offset the additional taxes from the IRA distribution. In effect, even though money is being taken out of the IRA, no additional taxes are paid.

The same thing will work for required payments of estimated taxes. One way to eliminate such payments is to invest enough so tax credits are generated that will equal the amount of estimated taxes due.

Tax credits are reported on Form 8586 and show up as a credit on line 52, page 2 of 2003 Form 1040. Visit Boston Capital on the web for details on latest offerings and prospectus. Work with your financial advisor or a professional to determine if a tax credit program is suitable for you and for help in setting one up.

PROSPERITY POINT 11: *How to Audit-Proof Your Tax Return*

> *"The Taxpayer. That's someone who works for the federal government but doesn't have to take a civil service exam."* —Ronald Reagan, late President of the United States

In December 1999 my wife and I drove our motor home to Key West, Florida for a vacation. As we entered Key Largo on U.S. Route 1, I saw a sign that really caught my eye: a huge billboard with a painting of a marijuana leaf. After we pulled into a park, I had to go back to see how they could get away with that particular bit of advertisement. As it turned out, it was the billboard for a place called "The Hemp House." It sold shirts and other goods made out of hemp, which is the legal, non-intoxicating plant version of marijuana. Still, there's no getting away from the implication of that billboard. Lounging in front of The Hemp House were a group of three bikers with their Harleys. I made a comment on what a nice day it was. One of them replied that it was never a nice day in the Keys. He then advised me to get out of the Keys because there are over seven different law enforcement agencies operating in the Keys, and they are constantly harassing people.

Now this particular gentleman was not one that I wished to engage in lively discussion, if you know what I mean. I thanked him for his advice and left. On the way back to the park, I couldn't help but reflect that I have traveled thousands of miles in our motor home, with car and motorcycle in tow, and never, not once, even in the Keys, have I ever been treated with anything but courtesy by law enforcement people. Perhaps that gentleman would find himself drawing less attention from police if he didn't spend his days hanging around a giant billboard advertising a controlled substance.

On tax returns, people sometimes do the equivalent of hanging around a billboard sure to draw police attention. I have seen some tax returns and handled some audits where the taxpayer might as well have attached a bright red note with the words "Please audit me" in bright Day-Glo letters.

The IRS computers where your tax returns are processed have a "discriminant function" built in. This is a series of tests and specific items that will determine if the return should be examined by an agent for possible audit. The precise components of the disciminant function are a highly kept secret at the IRS, but there are certain acts that draw unwanted attention. Avoiding those actions may audit proof your return.

Round Numbers

Large round numbers on any item deducted either on Schedule A, Itemized Deductions, or any business return, such as Schedule C, Self Employment Income, Forms 1120/1120S for corporations, or Form 1065 for Partnerships, are one of the audit triggers. If you have put down $1,000 for charitable contribution on your itemized deductions or, even worse, $500 for noncash charitable contributions, you have drawn attention to your tax return. You might not get audited, but you have sure increased the chances. If you have enough of these "triggers," you will get that invitation from the IRS, and I can guarantee you won't enjoy the party.

The reason this is a trigger is because you are required to keep records of these deductions as well as receipts. At tax time, you are supposed to add them all up—the $5, $15, and $22.50 you give to charities, and the $38.92 and $148.36 in used clothing you gave to Goodwill—and come up with your deduction. What are the odds it will come out to exactly $1,000 or $500, instead of $987 or $413? In the case of noncash charitable contributions, $500 is the limit before a more onerous form has to be filed. Putting exactly $500 is a dead giveaway that the taxpayer has not kept records and the number is pulled out of the air.

Ratios

The IRS is concerned with the ratios between income and expenses, especially on business returns such as Schedule C for self employment, even more so since the IRS made self-employed people a target. Self-employed people have greater opportunities for understating income or overstating deductions than employees getting paid on a W-2. Certain occupations that are known to deal more in cash, such as contractors, restaurants, and hair salons, are prime targets. Ratios are comparisons between income and deductions. Low income with high deductions draws suspicion. So be careful of your deductions. For instance, a contractor would have relatively high expenses for supplies whereas a hair salon would be lower. Sometimes business can be bad, and bad ratios or even losses could occur. Do not be afraid to deduct everything if it is legitimate and you have kept records and receipts. If you have not kept any records and you are just making up numbers, be careful!

Amended Returns

Amended returns by themselves are not an audit trigger, but the amended return is handled manually instead of by computers. So if your tax return has questionable items to begin with, be careful amending it for still another tax break. If the amount amended results in a big tax refund or is a large, unusual item, be sure you are on solid ground with this return. If your return is okay and you can document the reason for the amendment, don't be afraid to file the amended return.

Certain Tax Shelters

The IRS has identified certain shelters that it considers abusive. Such shelters generally only enrich the promoters and may lure unwary taxpayers into tax traps. One warning signal is that the shelter is promoted as "tax deductible going in, and tax free coming out." Always check with an independent tax professional before taking part in tax shelters.

Failing to Check Certain Boxes on Forms

One box that is closely watched on certain forms is the question on foreign accounts and credit cards. If you do not have one, be sure to check the NO box. If you have one, provide the information requested. The IRS is now checking people who have not reported foreign accounts. In 2003, it issued court-approved summonses to more than a dozen firms for information. Some of the firms included Starwood Hotels, Tiffany, British Airways, Barnes & Noble, MasterCard, Visa, and American Express. Questions on various returns involving trusts, partnerships, foreign accounts, and accounting methods should also be answered. Don't leave the questions blank simply because you don't have these things.

Not Paying Estimated Taxes for Self-Employed

I heard about this one from one of my contacts at the IRS. When a self-employed person has substantial earnings and has not paid estimated taxes during the year, it leaves a large tax bill due at the end of the year. The IRS looks closely at these returns because people who have not made their payments are more likely to overstate deductions and understate income to soften the tax blow. Even though there are penalties for not paying estimated taxes, it is likely an audit of those returns will result in greater deficiencies.

Excessive Automobile Donation Programs

Beware of programs that supposedly facilitate donating cars to charity. Some of the warning signs are that you are told you can get a deduction higher than your car is worth, or you can deduct even if you don't itemize. Wrong on both counts. You must itemize to get this deduction, and your total must be higher than your standard deduction to be useful. In addition, the IRS will look more closely at overblown prices of donated cars. Be ready to document the value of the automobile donation.

Matching Program

The IRS matches what is on your tax return to the amounts reported to the service by 1099s, K-1s, and other information forms. It expects that amount to be reported on your tax return somewhere.

Categorize Deductions

On business returns such as Schedule C, large deductions headed "Miscellaneous" may lead the IRS to decide you can't prove the deduction. Break deductions down according to individual categories. I never show a miscellaneous when I prepare a tax return. If I don't have an exact category, I use the one I think fits best.

Choose Your Preparer Carefully

You are responsible for your return. If there are errors triggering a return, you are the one who will be audited. When the IRS suspects preparers of incompetence or misconduct, it can force them to produce lists of clients, who may then face examination. This happened a few years ago to a mass-preparation firm in Brooklyn, New York. Preparers would ask the clients how much refund they wanted and then fraudulently increase the charitable deduction to get that refund. IRS computers picked up the pattern. The firm was closed and hundreds of its clients were audited.

You should use the following guidelines for choosing a preparer. Always use preparers with certifications. EAs, CPAs, and attorneys are the only ones authorized by the Treasury Department to represent clients before the IRS.

There are many good preparers out there without certification, but how would you know which are good and which are not? Never accept a return without the preparer's tax ID number and signature. A preparer is required by law to do this. If these spaces are left blank or state "Self Prepared," there's something wrong! Review your return. Are the figures on the return the ones you gave? Ask questions. The best of us can make a mistake, especially during the pressures of a busy tax season.

Neatness Counts

If you prepare your tax return yourself, show professionalism. Type it or use a computer program. If you must write it by hand, be sure it is clear, very legible, and neatly done. Never put inappropriate comments or remarks in the return or inside the envelope. It might make you feel good, but it may annoy someone at the IRS who could cause your return to be audited.

Constant Schedule C Self-Employment Losses

Especially when it offsets other income, the IRS will question the business purpose of the employment and classify it under the hobby rules or, even worse, as a fraudulent business for tax purposes only. This could turn out to be very costly. If you have genuine losses, don't be afraid to show them if they can be documented, but somewhere down the line, the business must show a profit.

Avoid Formal Membership in Barter Clubs

Barter club members exchange goods and services on a cashless basis. IRS regulations make such exchanges taxable, and in the past many clubs have failed to report these exchanges to the IRS. The IRS may force such clubs to produce membership lists to audit members.

Wrong Deductions on Line 27 of Schedule A

This is the line for deductions that are not subject to the 2 percent of AGI deductible. There are only a few allowed, like gambling losses to the extent of gambling winnings, and you will find them listed in the 1040 booklet. If you have a deduction for that line, be sure to write in clearly what it is or attach a statement. That particular line is looked at closely.

To tell you the truth, there is no such thing as audit proofing your return. You may fall victim to a random audit, and although the odds are high that it won't happen, it may. However, following the suggestions above will reduce the odds of being audited to almost negligible levels.

PROSPERITY POINT 12: *Ways to Save Money on Your Income Taxes*

"The income tax has made more liars out of Americans than golf." —Will Rogers

There are plenty of tax savings in the system without resorting to illegal strategies that can come back and bite you. Stay away from tax evasion schemes such as foreign trusts, secret offshore bank accounts, claiming your house as a "church," and other shady deals sold out of magazines or on the internet. Here are some legitimate strategies you can implement now:

- *Bundle deductions in a year you expect to pay more income taxes*. Pay the first property tax installment for next year in the current year. Pay your January state estimated payment in December (deductible on federal). If possible, arrange medical expenses such as dental and eyeglasses in that same year. When you do this, be aware of alternative minimum tax (AMT). Consult with a tax professional to plan the least possible AMT.
- *Ask your employer for fringe benefits instead of cash*. Health, dental, and group term life to $50,000 are deductible to your employer but not taxable to you. If you are in a profession where you supply your own tools and materials, ask your employer to pay for this expense and deduct it from your gross pay. In most cases, the employer can fully deduct those expenses, but as an employee business expense, it is subject to a 2 percent of adjusted gross income (AGI) deductible.
- *Consider a tax credit program*. A credit is a dollar-for-dollar reduction of your taxes. There are a number of legitimate credit programs backed by the Government for social reasons. Not all may be for you but anyone in a high tax bracket should consider them. Review Prosperity Point 10, on tax credits.
- *Don't be afraid of the home office deduction*. In the early 1990s, the IRS won an unfair court decision. A doctor in Chicago performed relatively minor surgery in three hospitals. He did not have an office in any of these hospitals, nor did he have an outside office. He used a room in his house for storing records, viewing X rays, and other related activities. He did not see patients at his home. The tax court ruled that since the "essence" of his business was not in his home, he was not entitled to the home office deduction. The IRS gleefully went after home office deductions until 1994 when Congress passed legislation that cancelled out this ruling. Right to this day, I will hear someone say, "Don't take the home office deduction, or you'll get audited." This is not true. If you have a legitimate business need for an office in your

home, you should take the deduction. Recent tax court ruling have even upheld deducting part of a room or space.

- *Don't borrow unless you can deduct the interest*. By now, you know that I recommend being debt free, but if you must borrow, make it via a home equity loan, which can be deducted.
- *Donate appreciated property*. If you want to make a contribution to a charity, instead of cash consider donating property that has appreciated in value, such as stocks, mutual fund shares, works of art, and collectibles. You will deduct the higher fair market value and not pay the capital gain tax due had you sold it. Let the charity sell it. They won't pay taxes on it.
- *If possible, bundle your medical deductions*. Taxes should not dictate medical procedures, but sometimes you can save money by planning certain medical expenses. If you are facing some sort of elective surgery, dental work, and eyeglasses over the next three or four years, it would make sense to get it all done in one tax year if possible. It has to be done anyway. Medical deductions have a 7.5 percent deductible against AGI. That means if you have an AGI of $50,000, your medical deductions do not start until you have spent over $3,750. This rule baffles me. How did they come up with that percentage anyway? A person facing high medical bills is in enough distress, and now here comes the IRS to make things worse. Write to your congressperson, folks!
- *Buy a house*. The best deduction of all! Points paid on the mortgage, interest and property taxes are all deductible. If you rent, you don't get to deduct anything. Your rent goes to pay those things and your landlord deducts them. Skip the middleman and buy! If you have lived in the house two out of the last three years, your will be able to walk away with up to $250,000 tax free gains, $500,000 for a couple.
- *Contribute to a tax-deductible IRA if eligible, or maximize contributions to retirement plans such as 401(k)s or 403(b)s*. Because it comes off the top, these contributions will save up to 35 percent and 7.5 percent (New York) in the highest brackets. Sure you can't spend it until you retire, but so what? I can tell you two things: You're going to get older, and you're going to need money in retirement. Where will it come from if you don't accumulate it? But then if you got this far in the book, you know this. You're already on your way to financial independence.
- *Remember those above the line adjustments to gross income on page 1*. "Above the line" means you don't have to itemize to deduct them. These adjustments include certain expenses for teachers, student loan interest, tuition and fees, moving expenses, and more. You will find them on lines 23 to 35 of 2004

Form 1040 page 1. This sounds like a duh statement, but you would be amazed how many people forget this. Remember, it's semi-voluntary!

- *Avoid the 2 percent floor for miscellaneous deductions*. Miscellaneous expenses such as fees for managing investment properties, legal and professional fees, tax preparation, and financial advice, all have a 2 percent deductibles when reported as miscellaneous expenses. The trick is to place them elsewhere on your return whenever possible. For instance, legal and financial advice could go on Schedule C if self-employed, and property management could go on Schedule E if renting property. Be sure you have a business purpose.
- *Shift family income*. By transferring income-producing properties to children, a family can realize tax savings. You must have a stable family situation because the property will now be owned by the child. For minor children, you will retain control as guardian, but shifting could set up problems for the future if your kid decides he wants a Porsche instead of college.

There you have it, a complete set of powerful money tools and ideas. These Prosperity Points will light your way toward financial independence as surely as spotlights on a darkened road. Be sure to visit www.prosperousboomer.com often for the latest updates. As tax laws and other regulations change, as the economy changes, we will be adding new, even more effective ideas and deleting those that are no longer valid.

PART III

Worksheet Section

"Success comes from having dreams that are bigger than your fears."

—Terry Litwiller

CHAPTER 16

Worksheets for Your Use

The following worksheets will help you take that all-important first step toward financial freedom.

WORKSHEET 1 Where Are You on the Road?

This is a "quick and dirty" exercise to give you a rough idea of where you are on the road toward financial freedom. As you learn more from this book, you may refine this so you know exactly where you are and what you must do. Right now, look at this as an eye-opening exercise that will tell you how far you've gotten. Here's the question you want to answer:

If I were to stop working today, how long could I live on what I've accumulated so far?

Step 1: Income Determination

Line 1: Current income from your last tax return.
Form 1040 page 1, line 22 (Form 1040A page 1, line 15) ______________

Line 2: Additional income not on your tax return
for whatever reason ______________

Line 3: Total current income = Line 1 plus Line 2 ______________

Line 4: Any income that will remain if you quit working:
Social Security if retired, annuities, etc. ______________

Line 5: Net income needed: Line 3 minus Line 4 ______________

Step 2: Current Assets (What You Have Accumulated So Far)

- Current fair market value (FMV) of your home ______________
- Current FMV of any other real estate ______________
- Current value of auto and trucks (Not what you paid for them) ______________
- Cash, money markets, savings, CDs and other cash equivalents ______________
- Retirement assets: 401(k), IRAs, pension plans, etc. ______________
- Invested assets: stocks, bonds, mutual funds, brokerage accounts ______________
- Net value of businesses owned, collectibles, precious metals ______________
- Anything else of value that can be sold for cash ______________

Line 6: Add up all the above for your total assets ______________

Step 3: Current Liabilities (What You Owe So Far)

- Mortgage and home equity loans ______________
- Mortgage and loans on other invested real estate ______________

WORKSHEET 1 Where Are You on the Road?, continued

- Auto loans or auto lease payments ____________________
- Total credit card debt ____________________
- Loans against 401(k) and other retirement plans ____________________
- Personal and other loans and debts ____________________

Line 7: Add up all the above for your total liabilities ____________________

Step 4: Determine Your Net Assets (Net Worth)

Line 8: Line 6 minus Line 7 equals your net assets ____________________

Step 5: Relationship of Needed Income to Net Assets

(The next line assumes income needs will drop by 20 percent if you retire.)

Line 9: Line 5 (net income) times 0.8 ____________________

Line 10: Take line 8 and divide by line 9 equals the number of years that your assets alone would provide income ____________________

For those of you analyzing this worksheet, there indeed are a number of omissions and other factors not worked in. That's okay, this is meant to be a fast assessment, maybe a quick wake-up call. Later chapters will address all these factors in detail.

WORKSHEET 2 Finding Out Where You Are—Your Season of Money

Have you ever seen one of those maps in tourist spots with a legend saying "You Are Here" and a big X marking the spot? The reason for these maps are obvious. It's impossible to get where you want to go unless you know where you are. That's what this exercise is all about, figuring out where you are financially so you can get where you want to be.

When you have completed this set of worksheets, you will know two things:

1. Your income needs as a financially independent person/family
2. The assets that must be accumulated to provide this cash flow

Right about now you may be thinking, Oh no, not another dreary worksheet exercise boring as watching a chess match, with the numbers coming out dreary and incomprehensible, telling me I'll have to work until I'm 90 because I did rotten and miserable so far!

Relax. It ain't necessarily so. I know you heard it before, but today really is the first day of your life. I promise that with a minimum of effort and no expertise, with just this book as your guide, you will start on the road to financial independence, right now, today. That's why you bought this book, isn't it?

Don't kid yourself, my friend. Make as honest an appraisal of your financial abilities as you can. However it turns out, it's okay. The plan itself will deal with it, and it will work out. But it will work only if built upon a foundation of truth and facts.

In the following exercise, you will discover three crucial pieces of information about your current financial position:

1. How much income is really needed to maintain your current lifestyle? This is a snapshot cash flow determination.
2. How much of that income can be provided from current assets without working? Exactly how far away are you from financial independence?
3. What will it take to achieve financial independence, to reach a point where cash flow is provided from assets, without the need to work?

You are going to use your previous year's income tax return, your Form 1040. Have that form next to you as you fill in the numbers on the worksheets.

Step 1: Total Income

Find your total income from your tax return.
Go to page one, Form 1040, line 22, This is your total income: $ ____________________

Step 2: Deductions from Total Income

1. Discretionary savings and investments: $ ____________________

WORKSHEET 2 Finding Out Where You Are—Your Season of Money, continued

2. Discretionary spending that can be stopped $ ____________________
3. One-time spending events $ ____________________
4. Work-related spending: $ ____________________
5. Guaranteed future income/annuities $ ____________________

Combined deductions from total income: $ ____________________

Read the following explanations of each line before you fill in the blanks. Add up all five lines to get your combined deductions from total income, and go on to Step 3.

WORKSHEET EXPLANATIONS

DISCRETIONARY SAVINGS AND INVESTMENTS. This is the amount you do not spend, the extra money left over at the end of the month. Perhaps you stash it in the bank, under the mattress, or into a mutual fund or other investment. Whatever it is and whatever the amount is, it is money you don't use to maintain your lifestyle.

DISCRETIONARY SPENDING THAT CAN BE STOPPED. *Be true to yourself!* Only put down those things you can stop spending for sure. If you're addicted to the health club, Starbucks coffee, dinner out Friday nights, or whatever it is, *do not put that down*. Your enthusiasm may prevail for a little while, but you will return to that spending you enjoy so much. Find a way to deal with it if it's too much money. Maybe cut out a day at the health club and go for a free jog in the park that day, find a cheaper restaurant, or whatever. Just make sure you are able to maintain the lifestyle change.

Another aspect of discretionary spending is a monthly payment expected to disappear within one or two years. Maybe it's a loan for that once-in-a-lifetime European vacation, the entertainment center, or that new Harley-Davidson you always wanted. Whatever it is, it must end and not be renewed.

ONE-TIME SPENDING EVENTS. This is spending not likely to be repeated. It could be discretionary, or it might have been a necessity. Perhaps it was a medical bill you had to pay before you got health insurance, maybe it was the last year of your child's college, or possibly it was a one-time cash gift to help a needy parent. It can also be a loan payment for these same purposes that will end in a year or two. It must be a one-time event with a high probability of not being repeated. Don't put down things like replacing the refrigerator, fixing the leaky roof, or getting a new engine for the car.

WORK-RELATED SPENDING. Be careful with this one. Most of the time, the savings are a lot less than people believe. You don't give up the extra car because you no longer have to work. You and your spouse will still want your own cars. You don't give up eating lunch or drinking coffee because you're retired. Some of the expenses that will go may be uniforms, training, and tools and equipment you are required to purchase for your job, tolls or train tickets for commutes, or expensive business wardrobes. If you are self-employed or own your own corporations, skip this one because most of the expenses will be factored into your business income tax returns, such as Schedule C, Forms 1120 or 1120S, and Form 1065.

WORKSHEET 2 Finding Out Where You Are—Your Season of Money, continued

GUARANTEED FUTURE INCOME/ANNUITIES. This would be an income stream that is *guaranteed* to kick in sometime in the future when you activate it, or when you reach a certain age. The most common form is a retirement plan like a 401(k), qualified, or government retirement plan. You may be guaranteed a monthly income of $500 per month at retirement or age 55. That's $6,000 per year income guaranteed. If you are approaching the age when you can collect Social Security benefits, that's a guaranteed income. Do not include this income if it is more than six years away.

Step 3: Additions to Total Income

1. Amounts borrowed for lifestyle $ ____________________
2. Nonrepeatable, one-time income $ ____________________
3. Income not reported on tax return $ ____________________
4. Tax-exempt interest $ ____________________
5. Necessary benefits provided by your employer $ ____________________

Combined additions to total income $ ____________________

Read the following explanations of each line before you fill in the blanks. Then combine all five lines to get your total additions to income, and go on to Step 4.

WORKSHEET EXPLANATIONS

AMOUNTS BORROWED FOR LIFESTYLE. These are the funds you borrowed when you had too much month left over at the end of the money. It could be credit card spending that wasn't paid by the end of the year or a loan to make ends meet. Whatever form it took, it was needed to simply maintain your lifestyle. This might open your eyes to some bad financial practices in your life. Don't worry about it for now. We will deal with it in the chapter on budgeting.

NONREPEATABLE, ONE-TIME INCOME. That would be money you got this year that you probably will not get in the future. It could be the sale of some investment or real estate, a special bonus at work, a substantial gift or inheritance, or any kind of cash windfall that is not likely to be repeated in future years. Why would you add that to income? Because you used it for your lifestyle, that same lifestyle you want to carry out when financially independent. If you saved it rather than spent it, it will be cancelled out because you have it put down in the discretionary savings in deductions from total income.

INCOME NOT REPORTED ON TAX RETURN. Don't look over your shoulder for the tax man breathing down your neck. There's income you don't have to report. Nonwork-related gifts from relatives, inheritances, return of capital, certain refunds, and more. Any income that is not required to be on your tax return must go on that line. If you've been a bad boy or girl and maybe have side income in the underground economy that you don't report on your tax return (gasp!), you must put it down on this line because it is part of the cash flow needed for your lifestyle. You might lie to the IRS (gasp again!) but always to thine own self be true. Write it down on the worksheet.

WORKSHEET 2 Finding Out Where You Are—Your Season of Money, continued

TAX-EXEMPT INTEREST. This is line 8B, page 1, of your Form 1040. This amount, even though it shows on your return, is not added to your total income. It is there to determine alternative minimum tax (AMT). But it is still income you have received and spent or saved. Either way this worksheet must factor it in.

NECESSARY BENEFITS PROVIDED BY YOUR EMPLOYER. These are the things that your employer is paying for while you are working. When you become financially independent and quit your job, these expenses will be yours, and so you must factor them in now. Health and dental insurance, a company-provided automobile, life insurance, and other benefits that do not show up on your tax return are some possibilities.

A frequently asked question is, Why aren't income and other taxes factored into this? They are. Taxes are part of your lifestyle spendings. If you are managing them with no problems, you have discretionary savings. If you are not managing them, you debt will increase and that will show up in the worksheet calculations.

STEP 4: Determining Your Retirement Income Needs

Step 1: Total Income		$	____________
	Minus:		____________
Step 2: Subtractions from Total Income		$	____________
	Equals subtotal:		____________
	Add:		
Step 3: Additions to Total Income		$	____________
Total Retirement Income Needed		$	____________

Step 5: Calculating Your Retirement Asset Needs

Now you can determine the assets you must accumulate in order to provide the retirement income needs you calculated in Step 4. Assets will be divided into two general categories: income investments and growth investments.

INCOME INVESTMENTS. This category is designed to provide immediate and intermediate (within one to three years) cash flow needs. It is a mix of income-producing investments such as bonds, CDs, and fixed annuities. The historical returns of such investments has varied between 3.5 to 6 percent. This category will comprise about 25 to 30 percent of the total investment portfolio.

GROWTH INVESTMENTS. This category has but one purpose, to make the pie larger over the long term, six years or longer. Growth will replace the income investments that are depleted, thus providing a never-ending source of retirement income. Growth investments consist of portfolios of mutual funds using the DABL system, stocks held in dividend reinvestment plans, and perhaps some real estate and variable annuities. The historical returns for such diversified investments has been 10 to 11 percent. The growth category will comprise about 70 to 75 percent of the total portfolio.

WORKSHEET 2 Finding Out Where You Are—Your Season of Money, continued

OVERALL RATE OF RETURN ASSUMPTION. My actual overall rate of return for both investment categories combined averaged over the last 20 years has been 9.9 percent. However, I believe this is far too aggressive an assumption for a couple of reasons. Here I am going to use a conservative assumption rate of 5.5 percent. This rate is very reasonable, and history conclusively proves it is achievable for every recorded ten-year period. In fact, not only is it achievable, but it is 3 to 4 percent lower than any ten-year period. The weighed historical average (10 percent for diversified growth and 5 percent for income) when applied on a 30 and 70 percent basis is 8.5 percent. So, you might ask, why shouldn't you use 8.5 percent instead of 5.5 percent and achieve financial independence that much faster? The answer, in one word, is inflation.

Inflation will always be present in varying degrees. When you hear retired people saying they are having a difficult time because they are on a fixed income, what they are saying is that their income has not increased as the cost of living has gone up. When you plan for financial independence, you must account for inflation. Every retirement/independence portfolio *must* have growth. Assets must increase to provide increasing income. The 3.5 percent growth spread will account for inflation.

I must warn everyone against using a higher rate of return. If you beat the rate, which I believe you will easily do just about every year, then your only problem will be having more money than you planned for. That's okay. But if you use a rate that is too aggressive and fail to reach it, then you will run out of money. For those who want their estate to grow, leaving a greater legacy behind, a lower rate of return should be used to provide greater growth than cash flow spending and inflation.

Retirement income needs from Step 4:		$ ____________
	Divided by:	
Rate of return assumption 5.5% as a decimal:		.055
	Equals:	
Retirement asset needs:		$ ____________

For example, if your retirement income needs from Step 4 are $41,000 annually, the assets needed for that income to continue for life with increases to match inflation are:

$41,000 ÷ .055 = $745,455

Step 6: Determining Your Current Assets

1. Cash, bonds, stocks, mutual funds, and any other liquid investments $ ____________
2. Collectibles $ ____________
3. IRAs, 401(k)s, and any other qualified retirement plan $ ____________
4. Real estate $ ____________
5. Other assets $ ____________

WORKSHEET 2 Finding Out Where You Are—Your Season of Money, continued

Please read the following explanations of each category of assets before you fill in the blanks. Now that a retirement asset target has been established, the next step is to determine how close you are to reaching that figure.

WORKSHEET EXPLANATIONS

Current Value of Stocks, Bonds, Savings, Mutual Funds, Cash and any Other Liquid Investments.

Current Fair Market Value of Collectibles. Do not include anything that has sentimental value or that you will not be willing to sell at some point. If it's unthinkable for you to sell that original issue Number 1 Batman comic book worth $100,000 or great-grandma's diamond brooch, do not include them. The same goes for "use assets." Those are the things you use in your daily lives. Sure the furniture may be worth $80,000 and the car $25,000, but so what? You can't turn those things into income, so don't put them down.

Current Value of all IRAs, 401(k), SEP IRAs, and the Amount You Are Vested in any Retirement Plans. Also include Keogh plans if you are self-employed. Any guaranteed retirement income should go in the Deductions from Income section in Step 2 as part of the guaranteed income/annuities line.

Current Fair Market Value of Real Estate You Own. Do not include your primary residence, the house where you live, unless you plan to sell it and buy a cheaper home. If that's the case, then use the *difference*, the windfall profit from the sale. You must live somewhere, and the value of your home is not something you will spend. As for using the home equity for cash, that's something addressed in later sections and should not be used here. How about the fact that the mortgage is very low, perhaps even paid off? This is be reflected in the income needs section. Not having a mortgage to pay lowers your income needs, which decreases the assets required for financial independence.

Any Other Asset Not Included Above, as long as the following two rules apply:

1. They can be sold for cash, either as an income stream or a lump sum.
2. You are willing to sell them.

Now that you have added up your assets, it's time to determine where you are. Let's stick with the example in Step 5. Here the income needed was $41,000, and for that the retirement asset need was $745,455. Suppose you added up current assets and they totaled $320,000:

Current assets:		$ 320,000
	Divided by:	
Retirement assets needs (Step 5)		$ 745,455
	Equals:	
Converted to a percentage: 43%		0.429

Now apply your percentage to find your financial season.

WORKSHEET 2 Finding Out Where You Are—Your Season of Money, continued

Spring: 75 percent or less

Summer: 75 percent to 100 percent

Fall: 100 percent or more

From this point on, as you go through each chapter, follow the recommendations for your season. The goal is to move from spring to summer and finally to fall. When you reach fall, you have reached financial independence. Your goal then becomes maintaining that independence.

This exercise should be done at least once a year to track your progress as you move through your financial seasons and to determine which recommendations to follow.

Notes

WORKSHEET 3 Debt Load Ratio Worksheet

Debt load ratio is a key indicator of your financial health. It is simply the percentage of your monthly take-home pay that goes directly to paying debts. Financial and banking experts recommend that no more than 20 percent of monthly take-home pay (excluding rent or mortgage) be used to pay debts. No more than 40 percent of monthly take-home pay should be used to pay all debts including your mortgage payment. These ratios are one of the most important factors used by loan officers to approve or deny mortgages and other loans. That's what it means when you hear someone has been denied a loan because of ratios.

Here is a worksheet to calculate ratios:

Ideal Ratio

Housing	35%
Transportation	20%
Debt payments	15%
All others, (food, entertainment, etc.)	20%
Savings and investments	10%

That's not the ideal for building wealth. In many cases, it will not be enough to bring you financial independence, lenders aren't concerned about your financial well-being, just your ability to repay the loan. You should strive to bring the savings and investments percentage as high as you can possibly reach. Now see where you are:

Step 1: Monthly Debt

1. Mortgage payment:
   Mortgage principal and interest; do not include taxes $ ______________________
2. Transportation debts
   Just your auto loan or lease monthly payment. $ ______________________
3. Other debts
   Credit cards, personal loans, consumer credit, etc. $ ______________________

Total debts
Add up 1 through 3 $ ______________________

Step 2: Take-Home Pay

Monthly take-home pay $ ______________________

Step 3: Calculate Your Debt Ratios

Mortgage debt ratio:
Mortgage payment (Step 1) $ ______________________
Divided by take-home pay (Step 2) $ ______________________
Equals ________ Convert to decimal for percentage ratio ______________________

WORKSHEET 3 Debt Load Ratio Worksheet, continued

Now convert the decimal to a percentage. Here's an example. Suppose the mortgage payment from Step 1 is $1,200 and monthly take-home pay from Step 2 is $5,000.

$1,200 ÷ $5,000 = 0.24 converted to percents = 24%

Transportation debt ratio:

Transportation debt (Step 1)	$	____________
Divided by Step 2, take-home pay	$	____________
Equals: ________ Convert to decimal for percentage ratio		____________

Other debt ratio:

Other debt (Step 1)	$	____________
Divided by Step 2, take-home pay	$	____________
Equals: ________ Convert to decimal for percentage ratio		____________

This ratio should be no more than 20 percent. Out goal will be to reduce it to zero.

Total debt load ratio:

Total debt (Step 4)	$	____________
Divided by Step 2, take-home pay	$	____________
Equals:________ Convert to decimal for percentage ratio		____________

This ratio should be no more than 40 percent. Out goal will be to reduce it to zero eventually.

Use these ratios to analyze your expenses in all areas. For instance, transportation costs should be no more than 20 percent of take-home pay. This includes gas, repairs, and insurance, in addition to car loans or lease payments.

Notes

WORKSHEET 4 Life Insurance Needs

Step 1

Annual living expenses of survivors
(spouses, children, etc.) $ ____________

Include taxes $ ____________

Less:

Step 2

Expected annual income of survivors (take-home after witholdings)

1. Survivors' earned income $ ____________
2. Social Security benefits $ ____________
3. Survivors' pension benefits $ ____________
4. Other income $ ____________

Total expected annual income of survivors $ ____________

Equals:

Step 3

Annual net living expense shortage (if any) $ ____________

If there is no shortage, skip to Step 5

Step 4

Capital needed for income to meet expense shortage

1. Annual rate of return (pretax) ____________%
2. Annual inflation rate ____________%
3. Years of income required ____________ yrs
4. Multiplication factor (from table) ____________

Capital required for income shortage
Step 3 amount multiplied by line 4 $ ____________

WORKSHEET 4 Life Insurance Needs, continued

Step 5

Lump sum expenses needed

1. Final expenses and estate settlement costs $ ____________
2. Payment of mortgages and other debts $ ____________
3. Cash emergency fund $ ____________
4. Children's educational expenses $ ____________
5. Other funds needed $ ____________

Total lump sum expenses needed $ __________

Step 6

Total capital needed

Step 4 amount plus Step 5 amount $ __________

Minus:

Step 7

Existing capital

1. Savings, stocks, bonds, collectibles $ ____________
2. IRAs, pension plans (less taxes due) $ ____________
3. Investment real estate, other $ ____________
4. Annuities and life insurance proceeds $ ____________

Total available capital $ __________

Step 8

Life insurance needs:

Step 6 minus Step 7 $ __________

WORKSHEET 4 Life Insurance Needs, continued

MULTIPLICATION FACTOR TABLE (for line 4, Step 4)

	Very Conservative	Conservative	Aggressive
	3% annual return, 5% inflation	4% return, 4% inflation	5% return, 3% inflation
Years of Income	**Multiplication Factor**	**Factor**	**Factor**
5	5.20	5	4.81
10	10.92	10	9.18
15	17.22	15	13.16
20	24.16	20	16.76
25	31.79	25	20.04
30	40.20	30	23.02
35	49.46	35	25.72
40	59.65	40	28.17
45	70.86	45	30.40
50	83.21	50	32.43

"The one who lacks the courage to start, has already finished." —UNKNOWN

CHAPTER 17

Conclusion

We have reached the end of your financial planning journey. Having completed the Progressive Plan of Action, you have a complete, active, and progressive financial plan. It's like having your own financial planner/CPA at your beck and call. In a sense, it's actually the beginning, the beginning of continuing freedom and financial independence.

Review your Progressive Plan of Action each month. Once you have done the initial planning, a monthly review will take about an hour. Once a year, repeat the Worksheet Exercise on determining your season and re-examine all sections to adjust your planning strategies as you draw closer to financial independence. That may take three or four hours per year. Overall, once you have begun and set these strategies, staying on track will

take 15 to 20 hours per year. That's less time then the average American will spend washing the car, getting haircuts, cutting the lawn, and doing crossword puzzles. I can't think of anything more worthwhile for an individual to do than assure financial independence. All manner of great and wondrous things flow out of living the nonlinear life and being free of drudgery.

In a way, I'm being selfish writing this book. I reached financial independence simply by putting into action the advice given in this book. I'm being selfish because I know that the more people I can take down this wonderful path to financial freedom, the better our society will be, and my family and me, along with you and your family, dear reader, will truly enjoy prosperity and longevity.

Appendix

Recommended DRP Stocks

A directory of my recommended DRP stocks follows. If you are investing a monthly amount, begin with the lowest minimum investment required for one stock in each industry. For example, Bob Evans Farms Inc., in the restaurant/food industry, requires $100 initial investment. If you have $100 monthly to invest, you begin with Bob Evans Inc., then go on to the next industry until you have one stock from each industry, then go on to the second stock in each industry until you have them all. Once you have a substantial portfolio, proportionately increase each stock. In effect, you will be creating your own mutual fund, and the investment style will be in harmony with the DABL system. You will continue to be well diversified and well allocated among various industries. You will be buying and

holding. This is not a trading system. This is a systematic buy-and-hold wealth-building method, and it's for the long term.

Each listing indicates if you can buy the initial amount direct from the company, and lists phone numbers and web sites. *Start with those companies first when buying minimums*. They are the easiest and least expensive to get started.

When you are ready to move on to stocks that require holding one or more shares, purchase them from a discount broker like Scott Trade, Charles Schwab, Fidelity, or Jack White. These are only a few brokers; there are many more. Obtain the actual stock certificate, and mail it in with your application. Be sure to follow the instructions from the company and use registered mail.

Most companies will have some sort of one-time initial fee averaging $10 to $15. There may also be other costs such as transaction fees of $1 to $2.50 or a purchase cost from $0.01 to $0.10 per share. In the long run, these costs are less than brokerage fees and, most importantly allow you to buy small amounts at low fees.

The directory of recommended DRP stocks is not in any particular order of importance, but separated by industry groups. There are some good stocks which I have excluded simply because their plan has cumbersome requirements. For example, Boeing Co. requires ownership of 50 shares before participating in its plan. Some plans require ownership of one share before joining. If that's the case, the requirement is indicated, and if you are just starting out on a monthly investment program, skip that stock until last. All other stocks, unless otherwise indicated, may be bought directly from the company for the minimum amount shown. Double check minimums when you call for the application. Or if you get an automated answering service, look at the instructions sent with the application; it will have the latest minimum amounts required.

Although www.prosperousboomer.com will have an updated DRP Directory, companies may change the details of their plan before I can post it on the site, so always check the literature for minimum investments and other requirements.

Be sure to check the fees for investments. A number of these plans have a set fee even though their minimum is low. For instance, a $2.50 fee may not be much, but if you invest $25 minimum, that's a whopping 10 percent. Better to accumulate and invest $300 to $400 at a time. The fee remains $2.50, but now it's less than 1 percent of the total invested. For plans that do not carry these fees, minimum amounts allowed are okay.

While many of the recommended DRP stocks can be purchased as IRAs, I do not recommend it because of the cost. IRAs have annual maintenance fees; for just about all of the recommended stocks, the IRA fee is $45 each. Owning ten stocks in IRA DRPs would be $450 per year, much too expensive.

RECOMMENDED DIVIDEND REINVESTMENT PLAN DIRECTORY

*** Indicates a favorite. I recommend you start with that one in that particular industry.

Diversified Manufacturing

3M Company
(651) 733-1110, (800) 401-1952
www.mmm.com

Requires owning one share; $10 minimum afterward.

Air Products & Chemicals Inc.
(610) 481-4911, (877) 322-4941
www.airproducts.com

Direct from company, $500 initial minimum or automatic monthly investments of $100 for five consecutive months; $100 minimum afterward.

Briggs & Stratton Corporation
(414) 259-5333, (800) 365-2759
www.briggsandstratton.com

Requires owning one share; $25 minimum afterward.

Caterpillar Inc.
(309) 675-1000, (866) 203-6622
www.cat.com

Direct from company, $250 initial minimum; $25 afterward.

Clorox Company***
(510) 271-7000, (781) 575-2726
www.clorox.com

Requires ownership of one share; $10 minimum afterward.

Dow Chemical Company***
(989) 636-1000, (800) 369-5606
www.dow.com

Requires ownership of one share; $25 minimum afterward.

General Electric Company***
(203) 373-2211, (800) 786-2543
www.ge.com

Direct from company, $250 initial minimum; $10 afterward.

Johnson Controls Inc.
(414) 524-1200, (877) 602-7397
www.johnsoncontrols.com

Direct from company, $250 initial minimum; $10 afterward.

Health Care/Nutrition Products

Abbott Laboratories
(847) 937-6100, (888) 332-2268
www.abbott.com

Requires owning one share; $10 minimum afterward.

Becton, Dickinson, and Company
(201) 847-6800, (800) 519-3111
www.bd.com

Direct from company, $250 minimum; $50 afterward.

Health Care Property Investors Inc.
(949) 221-0600, (888) 604-1990
www.hcpi.com

Direct from company, $750 initial minimum; $100 afterward.

Insurance

AFLAC Inc.
(706) 323-3431, (800) 235-2667
www.aflac.com

Direct from company, $1,000 initial minimum; $50 afterward.

Alfa Corporation
(334) 288-3900, (800) 937-5449
www.alfains.com

Requires owning one share; $25 minimum afterward.

Allstate Corporation
(847) 402-5000, (800) 448-7007, (800) 355-5191
www.allstate.com

Direct from company, $500 initial minimum or automatic monthly investments of $50 for ten consecutive months; $100 minimum afterward.

Marsh & McLennan Companies Inc.
(212) 345-5000, (800) 457-8968
www.marshmac.com

Requires owning one share; $10 minimum afterward.

Natural Gas Utility

AGL Resources Inc.
(404) 584-9470, (800) 633-4236
www.aglresources.com

Direct from company, $250 initial minimum; $25 afterward.

Atmos Energy Corporation***
(972) 934-9227, (800) 543-3038
www.atmosenergy.com

Direct from company, $200 initial minimum; $25 afterward.

MDU Resources Group Inc.***
(701) 222-7900, (877) 536-3553
www.mdu.com

Direct from company, $50 initial minimum; $50 afterward.

Diversified Electric Utilities

Alliant Energy Corporation
(608) 252-3311, (800) 356-5343
www.alliant-energy.com

Direct from company, $250 initial minimum; $25 afterward.

Cinergy Corporation***
(513) 287-2644, (800) 325-2945
www.cinergy.com

Direct from company, $250 initial minimum; $25 afterward.

Dominion Resources Inc.***
(804) 819-2000, (800) 552-4034
www.dom.com

Direct from company, $250 initial minimum; $40 afterward.

Energen Corporation***
(205) 326-2700, (888) 764-5603
www.energen.com

Direct from company, $250 initial minimum; $25 afterward.

Entergy Corporation
(504) 529-5262, (800) 225-1721
www.entergy.com

Direct from company, $1,000 minimum; $100 afterward.

Keyspan Corporation***
(718) 403-1000, (800) 482-3638, (800) 948-1691
www.keyspanenergy.com

Direct from company, $250 initial minimum; $25 afterward.

The Southern Company
(404) 506-5000, (800) 554-7626
www.southernco.com

Direct from company, $250 initial minimum; $25 afterward.

Water Utilities

American States Water Company
(909) 394-3600, (888) 816-6998, (800) 842-7629
www.aswater.com

Direct from company, $500 initial minimum; $100 afterward.

Philadelphia Suburban Corporation***
(610) 527-8000, (800) 205-8314
www.suburbanwater.com

Direct from company, $500 initial minimum or automatic monthly investments $50 per month for ten consecutive months; $50 afterward.

Southwest Water Company
(626) 915-1551, (800) 356-2017
www.southwestwater.com

Must own one share; $25 minimum afterward.

Real Estate, Mortgages, and Real Estate Management

Agree Realty Corporation
(781) 575-3400, (248) 737-4190
www.agreerealty.com
Requires owning one share; $100 minimum afterward.

Annaly Mortgage Management Inc.
(212) 696-0100, (800) 301-5234
www.annaly.com
Direct from company, minimum $1,000 and 25 shares; $250 afterward.

Anthracite Capital Inc.
(212) 409-3333, (800) 524-4458
www.anthracitecapital.com
Direct from company, $250 initial minimum; $100 afterward.

Boston Properties Inc.***
(617) 236-3300, (888) 485-2389
www.bostonproperties.com
Direct from company, $100 initial minimum; $100 afterward.

Duke Realty Corporation
(317) 808-6000, (800) 278-4353, (800) 937-5449
www.dukerealty.com
Direct from company, $250 initial minimum; $50 afterward.

Food, Restaurants, and Diversified

Albertson's Inc.
(208) 395-6200, (888) 788-5081
www.albertsons.com
Direct from company $250 minimum; $25 afterward.

Altria Group Inc.***
(917) 663-5000, (800) 442-0077
www.altria.com
Requires owning one share; $10 minimum afterward.

Anheuser-Busch Companies Inc.***
(314) 577-2000, (888) 213-0964
www.anheuser-busch.com
Requires owning one share; $25 minimum afterward.

Bob Evans Farms Inc.***
(614) 491-2225, (800) 272-7675
www.bobevans.com
Direct from company, $100 minimum; $50 afterward.

Pepsico Inc.***
(914) 253-2000, (800) 226-0083
www.pepsico.com
Requires owning five shares; $25 afterward.

Telecommunications and Information Services

ALLTEL Corporation
(501) 905-8000, (877) 446-3628
www.alltel.com
Requires owning one share; $50 minimum afterward.

Electronic Data Systems Corporation
(972) 604-6000, (800) 250-6016, (800) 278-4353
www.eds.com
Direct from company, $250 initial minimum; $25 afterward.

Equifax Inc.
(404) 885-8000, (888) 887-2971
www.equifax.com
Direct from company, $500 initial minimum; $50 afterward.

SBC Communications Inc.
(210) 821-4105, (800) 351-7221
www.sbc.com
Direct from company, $500 initial minimum; $50 afterward.

Verizon Communications Inc.
(212) 395-1525, (800) 631-2355
www.verizon.com
Direct from company, $1,000 initial minimum or automatic monthly investments of $100 for ten consecutive months; $50 afterward.

Banking and Financial Services

American Express Company
(212) 640-2000, (800) 842-7629
www.americanexpress.com

Direct from company, $1,000 initial minimum; $50 afterward.

Amsouth Bank***
(205) 320-7151, (877) 679-5704
www.amsouth.com

Requires owning one share; $50 afterward.

Bank of America Corporation***
(704) 386-5000, (800) 642-9855
www.bankofamerica.com

Direct from company, $1,000 initial minimum; $50 afterward.

Popular Inc.***
(787) 756-3908, (212) 315-2800, (877) 764-1893
www.popularinc.com

Direct from company, $100 initial minimum; $25 afterward.

Regions Financial Corporation***
(205) 944-1300, (800) 524-2879
www.regions.com

Direct from company, $1,000 initial minimum; $25 afterward. Note: Regions Financial just completed a successful merger/acquisition, and the information may have changed at time of printing. Check with the company.

Washington Mutual Inc.
(206) 461-8856, (800) 234-5835
www.wamu.com

Requires owning one share; $50 afterward.

Wells Fargo & Company
(800) 411-4932, (877) 840-0942
www.wellsfargo.com

Direct from company, $250 initial minimum; $25 afterward.

Oil, Gas, and Petrochemicals

ChevronTexaco Corporation***
(415) 894-7700, (800) 368-8357
www.chevrontexaco.com

Direct from company, $250 initial minimum; $50 afterward.

ConocoPhillips***
(281) 293-1000, (800) 814-0299, (800)842-7629
www.conocophillips.com

Direct from company, $250 initial; $25 afterward.

ExxonMobil Corporation***
(972) 444-1000, (800) 252-1800
www.exxon.mobil.com

Direct from company, $250 initial minimum; $50 minimum afterward.

Imperial Oil Ltd.
(800) 668-3776
www.imperialoil.ca

Ownership of one share is required; $50 minimum afterward.

Marathon Oil Corporation
(713) 629-6600, (800) 884-5426
www.marathon.com

Direct from company, $500 initial minimum; $50 afterward.

Entertainment

Disney (Walt) Company
(81) 560-1000, (800) 948-2222
www.disney.go.com

Direct from company, $1,000 initial minimum or direct monthly investments $100 for ten consecutive months; $50 minimum afterward.

Retailing and Distributors

Dollar General Corporation
(615) 855-4000, (888) 266-6785
www.dollargeneral.com

Direct from company, $50 initial minimum; $25 minimum afterward.

Home Depot Inc.***
(770) 433-8211, (800) 577-0177
www.homedepot.com

Direct from company, $250 initial minimum; $25 afterward.

Lowe's Companies Inc.
(336) 658-4000, (877) 282-1174
www.lowes.com

Direct from company, $250 initial minimum; $25 afterward.

Michael's Stores Inc.
(972) 409-1300, (800) 577-4676
www.michaels.com

Direct from company, $500 minimum; $100 afterward.

Procter & Gamble Company***
(513) 983-1100, (800) 764-7483
www.pg.com

Direct from company, $250 initial minimum; $100 afterward.

Walgreen Company
(888) 368-7346, (800) 286-9178
www.walgreens.com

Direct from company, $50 initial minimum; $50 afterward.

Wal-Mart Stores Inc.
(501) 273-4000, (800) 438-6278
www.walmartstores.com

Direct from company, $250 initial minimum; $25 afterward.

Technology

Hewlett-Packard Company
(650) 857-1501, (800) 286-5977
www.hp.com

Requires ownership of ten shares to participate; $50 afterward.

Intel Corporation***
(408) 765-8080, (800) 298-0146
www.intel.com

Requires ownership of one share to participate; $50 afterward.

International Business Machines Corporation
(914) 499-1900, (888) 421-8860, (888) 426-6700
www.ibm.com

Direct from company, $500 initial minimum or automatic monthly investments of $50 each for ten months; $50 afterward.

Pharmaceutical

Eli Lilly and Company
(317) 276-2000, (800) 833-8699
www.lilly.com

Direct from company, $1,000 minimum; $50 afterward.

Merck & Company Inc.
(908) 423-1000, (800) 522-9114
www.merck.com

Direct from company, $350 initial minimum; $50 afterward.

Pfizer Inc.
(212) 573-2323, (800) 733-9393
www.pfizer.com

Direct from company, $500 initial minimum; $50 afterward.

Newspapers, Publishing, and Broadcasting

New York Times Company
(212) 556-1234, (800) 317-4445
www.nytimes.com

Ownership of one share is required; $10 minimum afterward.

Tribune Company
(312) 222-9100, (800) 924-1490, (800) 446-2617
www.tribune.com

Direct from company, $500 initial minimum or automatic monthly investments of $50 for ten consecutive months; $50 afterward.

Business Services

Paychex Inc.

(585) 385-6666, (800) 937-5449, (877) 814-9688

www.paychex.com

Direct from company, $250 initial minimum; $100 afterward.

There you have it, folks, a sound portfolio, obtainable at low cost and a great part of the DABL system. Anyone who held this portfolio for the six-year period ending in December 2003 saw an average total return per year of 6 to 8 percent. If we go back to the ten years from 1993 to 2003, the return is double digit average for each year, beating bank CDs, Treasury bills, investment grade bonds, and inflation. This time period encompasses the years 2000, 2001, and 2002, the worst three years in a row for the markets since the crash of 1929 and the Great Depression.

By following this advice, readers will have put together their own low-cost, high-performance mutual fund, over 70 of America's greatest businesses spanning 17 industries. (Many of the companies recommended are international and cross over industries. I have listed them under their principal business only.)

You may have a favorite company and be disappointed by not finding it in this directory. There could be one of several reasons for this. They may not have a dividend reinvestment plan, or their plan may be too expensive or cumbersome to be listed here. To keep this list manageable, I have limited it to 70 stocks, thereby omitting many fine companies deserving to be listed. I will be placing additional listings on the web site, www.prosperousboomer.com for those who wish to own more issues in DRPs. I will also be removing some that I feel may be heading toward trouble. So keep in touch with the web site.

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