PART ONE

THE KEYS TO BUILDING WEALTH

CHAPTER 1

A Lifetime of Risk Management

Most families spend more time planning next summer's two-week vacation than they devote to planning their long-term financial futures! Have you ever wondered why that is? Planning a vacation is always fun. Making critically important financial decisions is often emotionally difficult. It's not fun, because it usually involves making difficult choices. We all know we should be saving more for our children's education and our retirement, but we also enjoy driving a brand-new car on our exotic vacation. Impulse buying has led the average family to credit card debt exceeding $8,000, the highest level in history. We also see personal bankruptcies at an all-time high.

For more than 30 years I have helped investors clarify and achieve their financial goals. I wrote this book because I have a mission to help you create a minimum of $100,000 of additional financial benefits for you and your family. Many of you can achieve additional benefits of $250,000, $500,000, or even more by following the strategies in this book.

The first thing we need to consider is how emotions affect our decisions. Having feelings, opinions, and attitudes is natural. It's part of the way we make most, if not all, of life's decisions. For example, consider the role emotions played in important decisions you have made, such as getting married (or getting divorced). Let's assume you are married. How did you approach that important decision? Did you conduct an in-depth review of your partner's financial history? Did you examine the health history of your partner and his or her family? Did you and your partner take psychological compatibility tests? Or, as for most of us, were other factors involved in your decision-making process?

Buying a car can also evoke all kinds of emotions. Do you enjoy haggling with the car salesman? Did the color of the car affect your decision? It did for me. My oldest grandchild picked the color for grandpa's new car.

Now let's look at how our feelings and emotions affect our investment decisions. When you think about investing and the word *risk*, what comes to mind? Most people think of the stock market. In the early to mid-1990s, I would hear statements like, "Investing is easy! Just buy a few good mutual funds and let nature take its course. I'll be rich in no time!" History prior to 2000 would certainly make you think investing is easy. In July of 1932, the Dow Jones Industrial Average was at a low of 40.56. In early January 2001, the Dow was over 11,000. This incredible long-term history would make you think everyone would feel comfortable being invested in the stock market today, but emotions—not just past performance—affect our decisions.

What investment decisions have you been making lately? Are your decisions being swayed by emotions? Consider the high-flying Nasdaq Composite Index, which closely reflects the performance of technology stocks. In March of 2000, the Nasdaq peaked at an incredible 5,048. On June 11 of 2002, it was down to 1,497, a drop of 70 percent in a little over two years. The news was depressing on June 12, 2002. The headline in the *St. Louis Post-Dispatch* shouted, "Market Plunge Wipes Out Tech-Stock Index." If you had inherited $10,000 that day, would you have bought into that depressing market or would you hold back, waiting for good news?

I'd like to share with you the results of four studies that address this important issue of investor behavior. Important studies like these are generally found in industry trade publications available only to investment professionals, but this is exactly the type of information that you, the investor, should be aware of.

The first study analyzed the investment return of active stock traders. Many investors prefer to buy and sell individual stocks rather than invest in mutual funds. Perhaps you are a successful day trader. In recent years, traders have owned Cisco and Microsoft stock for an average of only eight days before selling and moving on to something else. There are a few day traders who are successful, but not very many, according to this study by Terrance Odean published in the April 1998 issue of *Journal of Finance.* Odean found that frequent traders earned only 11 percent during the six years prior to his study, compared to the stock market average of 18 percent during that period. Taxes and trading costs might be part of the problem, but the biggest obstacle is emotional buying and selling.

Rather than day trading individual stocks, let's assume your serious money is in mutual funds, the investment of choice for busy baby boomers. The second study, "Quantitative Analysis of Investor Behavior," was completed in 1999 by DALBAR, a company dedicated to analyzing mutual fund investor behavior. That study revealed important facts. During the 15-year period prior to the study, the stock mutual funds returned, on average, 17.9 percent per year—not bad at all. But only a small percentage of fund investors experienced this investment rate of return. Why? During this 15-year period, the average investor moved from one fund to another every 2.8 years, hoping to improve the rate of return. Did it work? No! This behavior of jumping from one fund to another caused the average mutual fund investor to experience only a 7.25 percent average rate of return over this 15-year period. This behavior cut potential investment return by more than 50 percent.

These statistics are for years prior to 2000–2002! Can you imagine how recent market volatility is affecting investor behavior? Forget the general public for a moment. How about you? How long have you held the mutual funds you currently own? Have you made drastic changes in the last few years? Do you have the urge to substantially alter your portfolio in the near future? Why do you change from one fund to another? Are your decisions based on emotion or on portfolio changes necessary to adhere to a specific investment strategy? Do you have a well-defined investment strategy, or are you making decisions based on what feels good at the moment?

Consider the results of a third study completed by the Phoenix Investment Partners and reported in the April 2001 issue of *Journal of Financial Planning.* This study covered a different time frame, from January 1990 through March 2000, and focused on a different investor behavior. Most mutual fund companies advertise their previous year's best fund. Unfortunately, many investors are attracted to these funds because of the heavily advertised recent past performance. This study pointed out that purchasing last year's best-performing fund is not the answer. The mutual fund investor using this strategy experienced a 20 percent lower return than the mutual fund industry average. Most of us are familiar with the investment rule, "Buy low, sell high." Chasing last year's winner breaks this rule. Buying last year's heavily advertised winner usually results in below-average future performance. In disgust, we sell that disappointing fund and seek out another.

And how do you feel about taxes? Taxes will play a major role in your financial success over time. Are you paying as much as 35 percent in taxes on short-term gains triggered by active trading? Or are you paying the more favorable long-term capital gains tax of 15 percent on gains taken after one year? Do you sell your winners or your losers when you sell? The fourth study is another report by Terrance Odean, published in the October 1998 issue of *Journal of Finance.* This study found that most sellers tend to sell their winning stocks, triggering taxes. From a tax standpoint, they would be better off selling their losers and using the tax loss to offset capital gains and ordinary income.

These four studies should convince you that you may need to rein in your emotions when making future financial decisions.

As you're probably aware, income taxes will have a major impact on the future benefits you and your family enjoy. If a major portion of your portfolio is designated for your children's education or your future retirement, is it compounding without current taxes? Are you doing all you can to compound these investments without current taxation?

Most of us are building sizable accounts in our employer-sponsored retirement plans. How do you allocate your investments in the company's retirement plan? Let's assume your employer has a 401(k) plan that allows you to choose between 10 accounts—nine stock mutual funds and one bond mutual fund. You might put equal amounts in each of the 10 funds. The result? You end up with 90 percent in stocks and 10 percent in bonds, which may or may not be the best mixture. What if your 401(k) plan offers only four accounts—three stock funds and one bond fund? Again, if you invest in each account equally, you have an entirely different allocation—75 percent stocks and 25 percent bonds.

Real wealth, lasting wealth, requires even more decisions. For example, most investors don't want to experience even a temporary market decline of 20 to 40 percent in their portfolio. How would you react to a permanent loss of as much as 67 percent? Many of us are building our wealth in employer-sponsored retirement plans such as 401(k) plans, 403(b) plans, 457 plans, profit-sharing plans, and/or pension plans. Most of us also have IRAs. In most cases, we have little or no cost basis in these accounts, which means these assets will be subject to income tax when they're used for retirement income. These assets will also be taxed when they are liquidated by our beneficiaries. They might also be subject to estate taxes. Wealthy families might have to pay estate taxes, which can be as high as 49 percent in 2003, as well as ordinary income taxes on inherited qualified plan and IRA assets. Without careful planning, estate taxes and income taxes could confiscate up to 67 percent of this portion of your estate, leaving as little as 33 cents of every dollar for your children and grandchildren.

Many baby boomers feel there is little need to save for retirement. Therefore, the savings rate of this generation is lower than that of any previous generation in history. The younger generation X is saving more for the future than the baby boomer generation. Perhaps boomers expect to receive a large inheritance from their parents, but this may not happen. We have just seen that taxes can drastically affect this picture, but there are other issues as well. For example, many parents do not intend to distribute their estates evenly between all of their children. I see more trust planning being done by today's concerned parents and grandparents than by previous generations. They want to make sure their estates are carefully distributed according to rules established in their trust document. In addition, today's retirees are also spending more of their assets as they are living longer, more active lives. Interest rates have dropped drastically since the early 1980s. Many retirees have seen their CD rates drop from 18 percent to less than 3 percent. Many retirees are being forced to spend their principal or purchase immediate annuities to create adequate income. Your parents (and you) will also have to deal with long-term health care needs, which can drastically reduce assets over time. And, some parents just don't care about leaving a large inheritance to their children. Many are planning to leave some (or all) of their estate to charities. In short, you need to build your own assets rather than hope for a large inheritance.

These are just some of the financial concerns you should have. Dealing with these issues is not always fun, but it is critically important. I'll make the process as painless as possible. I promise it will be financially and emotionally rewarding.

First, recognize there are several risks that must be addressed to be financially successful:

- *Market risk:* Market volatility is a fact of life, not just for this year but for the rest of your life.
- *Inflation risk:* Prices can easily double, if not triple, during your years in retirement. (If inflation averages 3.75 percent, you will see prices triple during your retirement. At 5 percent inflation, prices will more than quadruple.)
- *Tax risk:* Income taxes and estate taxes can be more destructive to building and keeping your wealth in your family than market risk.
- *The risk of outliving your income:* Baby boomers are living longer than their parents and grandparents. The average life expectancy increased by more than three decades in the last century, and this trend continues today. Your sources of retirement income will be substantially different than the sources that provided your parents and grandparents with a comfortable retirement. Social Security will play a smaller role in creating your retirement income. Your parents and grandparents retired with lifetime income provided by their employer's defined benefit pension plan. Few baby boomers will enjoy a monthly pension check for life. Why? Today's employers provide mostly 401(k) plans, profit-sharing plans, or 403(b) plans. These plans place the investment responsibility on the employee. Because of these changes, many boomers run a major risk of outliving their retirement income.
- *Long-term health care risk:* We are living longer, healthier lives. But the day may come when there are additional demands on your savings and investments. Long-term health care costs can drain a family's resources. We have all heard horror stories about the costs of nursing homes. You need to make some decisions on how you will create the cash needed to meet these expenses.

All of these lifetime risks will be dealt with in the coming chapters. I will help you understand these risks and provide practical solutions to allay your fears. Learn about each risk; get to know each risk intimately, so there will be no surprises down the road. According to the Employee Benefit Research Institute, 80 percent of current retirees have household incomes of less than $23,000, including Social Security. I don't believe this is the retirement plan you have in mind for yourself.

Eleanor Roosevelt pointed out, "You gain strength, courage, and confidence by every experience in which you stop to look fear in the face." This book will help you recognize and deal with the biggest mistakes investors make with their money. Please read the following list carefully. It is time to meet the enemy!

The Eight Deadly Mistakes Investors Make with Money

They Make Investment Decisions Based on Emotion Rather than Logic

They tend to get excited about one type of investment, which leads them to take too much risk. It's easy to fall into the emotional trap, experiencing greed, impatience, concern, fear, panic, and so on. Investors need to follow time-tested investment strategies that work, such as establishing a diversified long-term investment portfolio.

They Fail to Plan for the Devastating Effects of Inflation

Planning for long term needs, such as a child's college education or your retirement, must be adjusted for inflation. Remember, inflation never retires!

They Don't Take Advantage of Opportunities to Control Taxes on Their Savings and Investments

Taxes can often be avoided or deferred by using IRAs, 529 college savings plans, annuities, trusts, and employer-sponsored retirement plans. You may not be able to control inflation, but you certainly can control your taxes.

They Have Not Decided What They Want to Accomplish with Their Money

How important is your children's education? With advanced planning, the cost of your children's education can be dramatically discounted. How about your retirement? Will you be prepared for a secure retirement that will last 20 to 40 years? Without careful planning, you will not meet your goals.

They Don't Protect Themselves, Their Families, and Their Assets with Adequate Insurance

Younger breadwinners need to protect their families by purchasing adequate life insurance and disability income insurance. Older investors need to preserve their investments by insuring against loss with adequate long-term care insurance. Wealthy individuals need to protect their assets from estate taxes, which can reduce their estate by as much as 49 percent.

They Fail to Establish a Written Plan for the Orderly Distribution of Their Wealth

Do you have the necessary legal documents, such as a will, a durable power of attorney, and possibly a trust, to carry out your wishes? An effective plan needs to be designed for the distribution of your wealth.

They Procrastinate, Finding It Much Easier to do Nothing than to Address Difficult Decisions

We say we are too busy, but in reality we don't want to deal with difficult, emotional issues. But we are responsible for those we love and therefore we must make important decisions and then take necessary action. Dealing with procrastination is the only way to create financial peace of mind.

They Don't Seek Professional Advice

Creating and implementing a plan can be difficult. Mistakes and procrastination can be very costly. Seek professional guidance. Lawyers, CPAs, and qualified financial consultants have the expertise to make sure you avoid serious mistakes in your planning. They have the resources, tools, experience, and expertise to help you create, implement, and adjust the plan that will bring financial peace to you and your family.

Many of my comments throughout this book are focused on baby boomers for several reasons:

- There are so many of you! You are the largest generation in American history. There are 76 million of you raising kids and preparing for retirement.

- Every seven seconds, one of you turns 50. Most of you want to retire in far less than 15 years.
- Your generation is spending too much and not saving enough for the future.
- Time is no longer your friend. You must act now to create a secure retirement for you and your spouse.

However, this book is not just for baby boomers. Many of you are part of a younger generation. If so, take advantage of your youth. Time is your number one asset. Use it to your advantage and you can accumulate tremendous wealth. You need to learn how to avoid the mistakes made by older generations. Most of you understand that Social Security will change drastically before you retire.

If you are older than the baby boomers, there is much you need to do to get your financial affairs in order. As of April 17, 2002, new IRS regulations make it possible for you to leverage the value of your IRA in ways never before feasible. With proper planning, your IRA can be worth 6 to 10 times more when passed down to your heirs. For example, a $100,000 IRA left to your children can now be worth up to $1 million in income for your heirs. And there are several new tax laws that make it possible to create additional benefits for you and your family. For example, many of us are grandparents and we would like to offer financial help in the funding of our grandchildren's future college expenses. There are new programs with special tax incentives that will have a tremendous impact on your ability to build savings for these future expenses. If you take full advantage of these new programs, it is possible to reduce future college out-of-pocket costs by up to 75 percent, and possibly even more.

I have spent more than 30 years learning what I will share with you in this book. Let me give you some highlights of my background. My investment career began in 1968, when I joined the St. Louis office of an investment firm. I was honored that year as Rookie of the Year. The national recognition was rewarding, but it was a painful year. I made many mistakes and relied on trial and error. I had little confidence in myself and in the recommendations I was making. I was fortunate to get practical advice from two men who helped me survive my first few years without hurting my clients or myself. For 10 years, I helped individuals like you clarify their goals and take the steps to make it all happen. Using financial tools such as stocks, bonds, mutual funds, annuities, and life insurance, we established plans to meet their financial goals:

- Reduce their income taxes year in and year out
- Create the capital necessary for a long, enjoyable retirement
- Provide the funds for higher education for their children and grandchildren
- Reduce their estate taxes to preserve the assets they have spent a lifetime building
- Leave a legacy to those charitable organizations that are important to them

Financial goals have not changed for most families since the 1970s, but the tools available to meet these goals have changed dramatically.

The firm was growing rapidly, and new employees were faced with the same problem I had experienced: little or no training. I made a decision to help others beginning their careers. By the mid-seventies, I was wearing two hats—helping my own clients and teaching new investment brokers in the firm to be successful. By the early seventies, the office had grown to over 60 investment professionals. Unfortunately, I was stretching myself too thin. I had to make a difficult decision: Either focus on my personal clients or devote my energies to training other investment professionals to do a better job with their clients. I chose training.

In 1978, I joined a top-10 New York Stock Exchange firm at their national headquarters in St. Louis. I joined this exceptional investment firm because of their commitment to initial and ongoing training of their financial professionals. Few firms are as dedicated to helping their representatives be the best they can be. I truly enjoyed this opportunity to teach and advise so many professional financial consultants. When I joined the firm, there were 970 consultants. By the time I retired in 2002, the firm had grown to over 7,300 professionals throughout the country. I like to feel that I played a significant part in this incredible sevenfold growth. Many of my days were spent teaching in the classroom. I've also had the opportunity to meet and address 7,000 to 10,000 investors per year at seminars conducted throughout the country. Much of my time was spent helping these professionals create personalized solutions for their clients with unique situations. These professional men and women were my clients for over 23 years. My goal was to prepare them to help you. In short, for over 23 years, I advised the advisors.

Now my career is coming full circle. I began by working with individual investors. This evolved into training and advising investment professionals, which led to talking and listening to thousands of investors by way of public seminars. And now, through this book, I hope to provide vital information to all individual investors looking for answers.

I do not want to be your personal advisor—I want to be your preadvisor. When it comes to selecting an advisor, you will be better served if you select a qualified individual living in your community who can provide you and your family with the personal attention you deserve. We will discuss this in Chapter 13.

Today, there is more financial noise (not news) than ever before. Much of my time is spent sorting through this noise to clarify those things that are important to you, the investor. I will provide you with the education and tools necessary to get you started. Many of you will choose to make your own decisions. Many will prefer to work with a qualified financial advisor. In either case, as your preadvisor, I'll help you get prepared.

Many years ago, a wise financial professional taught me a very important lesson that has become my motto: "I am not in the business of making people rich. I'm in the business of making sure they will never be poor." Financial peace is an attainable goal for you and your family. It is my goal to help you develop a solid plan based on fact and reason rather than the emotional noise of the day. You will learn practical tips designed to reduce your risks and make it possible to fulfill your dreams for you and your family. Your life will be far less hectic if you avoid the eight deadly mistakes investors make with their money. Small mistakes are OK. It is the big mistakes that can really hurt you!

Before you start the next chapter, I want you to slow down. Take a big breath and relax for a moment. Let me share with you my wife's advice: Don't speed read this book! Slow down and read carefully. You paid good money for the advice you are about to receive. Take notes and underline as you read. Get your money's worth. Financial peace is within your reach, so let's get started.

LESSONS AND STRATEGIES

The Eight Deadly Mistakes Investors Make with Money

1. They make investment decisions based on emotion rather than logic.
2. They fail to plan for the devastating effects of inflation.
3. They don't take advantage of opportunities to control taxes on their savings and investments.
4. They have not decided what they want to accomplish with their money.
5. They don't protect themselves, their families, and their assets with adequate insurance.
6. They fail to establish a written plan for the orderly distribution of their wealth.
7. They procrastinate, finding it much easier to do nothing than to address difficult decisions.
8. They don't seek professional advice.