Inside Highlights

"There are only two economists in Congress and hundreds of lawyers." --Thomas Sowell, economist, senior fellow, Hoover Institution

"The ultimate result of shielding men from the effects of folly is to fill the world with fools." --Herbert Spencer, British philosopher (1820-1903)

Tax and Financial Strategies

Wealth Creation Strategies

The Wealth of Individuals
Part 1

Con men and other advertisers often sell false formulas promising great wealth. Yet, if we want to find a method of creating wealth that actually works, we need to look at it from a more realistic perspective.

This won't be as exciting and emotional as the come-ons that would have you believe you can get wealthy by working from your home a few hours per week or flipping foreclosures. It might even be a bit boring—after all, we'll need to talk "numbers." Eccchhh. But I promise you will gain insight into wealth you won't read—or hear—anywhere else.

Avoid borrowing for consumables

Compound interest is often called the eighth wonder of the world. It's simple enough—if you earn 10% per year on $100, you'll have $110 in a year. The $110 increases not by $10 the following year, but by 10% of $110, or $11, and so on. At first it's practically imperceptable, boring and slow. But consider when that first $100 has grown to $500 (in just under 17 years at a 10% return), it's earning as much in two years as was originally invested. The results, given enough time, can be pretty amazing.

You might imagine that you don't want this "wonder" to work against you. If you borrow $2,000 at 18% to pay for a vacation today and borrow just enough extra each year to offset the interest, you'll owe $10,468 in 10 years. If you borrow $2,000 annually to pay for such luxuries, you'll owe, with interest, $47,042 after 10 years. From another vantage point, a debt of $25,000 today represents only a tad more than $1,000 borrowed per year at 18% for 10 years with any payments offset by additional spending the entire time (so the debt increases by the amount of interest charged and compound interest works its miracles against you). Think about it. Is it really worth an extra $1,000 a year in consumption to end up owing $25,000 after only 10 years? Will you even remember what you bought? (You may want to re-read this paragraph before continuing. It's important stuff.)

While you might conclude there is no excuse for borrowing to consume unless your very survival is at stake, some things are worth borrowing for, albeit at lower rates. A good education, for example, may pay dividends worth many times the investment. A home or rental property bought right (i.e. not at inflated bubble-prices) can be worth mortgaging. An investment in one's business or one run by others via ownership of individual stocks or stock mutual funds might work out, but carries greater risk. If you fail to earn more than the cost of the debt, leverage works against you and you could end up with less than nothing, as have all-too-many recent stock market investors and home buyers.

Stability of growth, and patience too

Investments have a nasty habit of growing (or shrinking) in spurts. While according to InvesTech Research (www.Investech.com) average annual returns in the U.S. stock market were 9.6% from January 1, 1928 through February 29, 2008 ($10 grew to $15,279), if you had missed the best 30 months your return would have been 4% ($10 would have grown to only $215). If you'd missed the 30 worst months, you would have achieved a 19.2% rate of return while watching that $10 grow to over $12 million (note the extraordinary effect of seemingly small differences in rates of return and compounding over time). We need to accept the idea that just as biological and human technological evolution move in spurts following and followed by long periods of relative stability, so do markets. Another way of viewing this is we live in a non-linear world subject to massive discontinuities. Therefore, it is crucial to be patient while awaiting the inevitable; the inevitable happens at unexpected moments.

This suggests we should make some attempt to time purchases when invest-

ments become dramatically undervalued or sales when absurdly overvalued. A 90% plummet in value requires an increase of 1,000% just to break even. A 50% drop requires a rebound of 100% to return to square one. While smaller declines of 10-15% don't need much of an increase to get you back to even, in order to grow an investment by a mere 6% annually each 10% decline must be offset by a 25% increase. The fact that this is difficult to pull off may account for the first rule of great investors: lose no principal.

Nice and steady…

Year	1	2	3	4	5	6	7	8	9	10
Invest $1000@	25%	-10%	25%	-10%	25%	-10%	25%	-10%	**25%**	**-10%**
Grows to	$1250	$1125	$1406	$1266	$1583	$1424	$1780	$1602	$2003	**$1803**
Invest $1000@	6%	6%	6%	6%	6%	6%	6%	6%	**6%**	**6%**
Grows to	$1060	$1124	$1191	$1262	$1338	$1419	$1504	$1594	$1689	**$1790**

In fact, we can't realistically expect continuous 25% annual increases in the aggregate value of our investments. If you begin your investment program at age 18 with $1,000 and die 60 years later with $90 million, you averaged 21% annual compounded growth. While Berkshire Hathaway's Warren Buffet has achieved this rate of return for 40 years, can you? Generally, rather than shooting for home runs, consistent steady growth and doing everything you reasonably can to avoid large losses is the safest and surest way to increase wealth.

This is not to suggest you should never take a flyer. You should—but only when the downside risk is zero and the upside potential is huge. Such opportunities are extremely rare, however. I've done it twice in my life, but that's a discussion for another time.

Stability in one's personal life is important, too

Many people involuntarily lose half of their wealth part way through their lives because they made an unfortunate life partner decision. Therefore, being careful who you marry is crucial if you hope to dramatically increase the odds you'll be worth a few million by the time you retire. Most think the biggest cause of divorce is financial woes. Since mature people usually deal with such issues properly, we need to delve deeper. According to my research, the greatest cause of financial misfortune is alcohol and other-drug addiction in one party or the other. Since addiction is also the greatest cause of emotional turmoil and immaturity in adults (the typical recovering addict tells us he stopped growing emotionally the day he triggered his substance addiction—average age 13) we might surmise that the primary underlying cause of divorce is addiction, which is at the root of a large plurality (if not majority) of interpersonal travails and financial disarray. My work elsewhere (particularly, *Drunks, Drugs & Debits: How to Recognize Addicts and Avoid Financial Abuse*) supports this hypothesis. If I'm right, those who learn to identify alcoholism and other-drug addiction in the early stages gain an enormous advantage in wealth creation, not to mention happiness.

We also dilute wealth with transaction costs and taxes. While few need be concerned with income tax on the sale of one's main home, buying and selling costs averaging 10% contribute enormously to dilution of net worth. Selling a home for $500,000 can easily run $40,000 in commissions, escrow fees, title insurance and local taxes. Factor in another $10,000 in points and other costs to purchase a home in a similar price range and, not even counting moving costs, you're losing something north of $50,000 whether your equity is $100,000 or $400,000. If $300,000 is owed, 25% of your net worth in the home ($50,000 out of $200,000 equity) is instantly wiped out.

This is not to suggest there are no sound reasons to move. These include:
1. change of job
2. deterioration of the neighborhood
3. you've outgrown your home and there's no way to add on that makes sense
4. retirement
5. high state and local taxes
6. change in family circumstances
7. health considerations

Otherwise, moving should be avoided.

Remember the part about how much you have to earn after losing principal just to get back to even? This applies to losses from your own actions, such as reducing equity by moving. Let's say you voluntarily forfeit $50,000 by selling the old home for $500,000 and buying a new one for $450,000, both with $300,000 mortgages. The new home must increase in value by over 11% just to get back to where you were if you hadn't sold, or more than 2% per year for five years. (Essentially, you just delayed the start of your investment program by the number of years it took to get back to even, the cost of which you'll see shortly.) If you start over with a net worth reduced by $50,000 after selling your $500,000 home and home prices increase by 5% per year (which might even happen again from the market bottom, wherever that is), your net worth will be $216,000 less after 30 years than if you had stayed put. (See table on the next page.)

$500,000 grows to a lot more than $450,000 at 5% per year

Years later	Keep the old home worth $500,000	Sell, pay $50,000 in costs and buy for $450,000	You lost this much in net worth
Now	$500,000	$450,000	$50,000
10 years	$814,000	$733,000	$81,000
20 years	$1,327,000	$1,194,000	$133,000
30 years	$2,161,000	$1,945,000	$216,000

The same idea of avoiding equity dilution applies to selling real estate other than your home, but even more so if you'd pay tax on a profit. While you can exchange real estate held for investment tax-free, a second home doesn't even qualify. (But then, second homes and vacation timeshares generally make little or no economic sense in the first place.) However, there are several valid reasons to sell or trade investment property, including:

1. what you own has become tremendously overvalued, especially relative to property you can exchange into
2. your psychological or even physical health is suffering due to the trials of dealing with tenants or governmental entities
3. you exchange land for income-producing property

Otherwise, try to avoid selling investment real estate that you already own.

But first, save

Before you own any real estate, stocks, businesses or other investments, you obviously need to save. The cost of living seems to preclude this, especially when you're young. But does it really?

Most people become accustomed to living in a particular style. Growing up, they get used to accoutrements that come with parents. Their first jobs generally supply funds with which to purchase non-essentials. Young people don't want to give up such luxuries and often go into debt at the outset of their independence—which ironically makes them more dependent than independent.

A mental picture of what it really costs to spend can help reduce waste. Costs include taxes and the opportunity cost of having failed to save and ultimately invest whatever is spent.

Paying taxes means that one must earn more—sometimes considerably more—than what is spent. Let's take a look at what that cost of, say, dinner really is.

What do you need to earn to spend $100?

Tax bracket	Pre-tax earnings needed
17%	$120
22%	$128
32%	$147
42%	$172

Next, let's convert this money into time. How long did it take you to earn the funds you squandered—ok, enjoyed—on dinner? If you're in the 10% tax bracket, you're probably not earning much more than minimum wage. Those who earn $7 hourly are in the 17% federal/Social Security tax bracket and must work 17 hours to spend $100. Those earning $30 per hour are probably in the 32% combined brackets and must work almost five hours. Since it's worse for those living in states with income taxes and for the self-employed, the latter of whom must foot the entire Social Security tax, this should be viewed as a minimum cost in terms of number of hours one must work to spend that $100.

How long did you work to spend it?

Bracket	Let's just say you earn	You spent how many hours working for that dinner?
17%	$7/hour	($120/$7=) 17
22%	$15/hour	($128/$15=) 8.5
32%	$30/hour	($147/$30=) 4.9
42%	$60/hour	($172/$60=) 2.86

Now let's convert this to what might have been earned by engaging in an act of self-denial and, rather than spending it now, saving and investing it for your future. You can invest either in a retirement plan such as an IRA, an asset outside of a plan such as stocks or stock mutual funds, or in interest-bearing instruments such as CDs or bonds. We'll assume equal rates of return between instruments even though, over the past century, stocks have yielded far greater returns than CDs and bonds (and should continue to do so if and when stocks crash back down to bargain levels). Another way of viewing this is that the relatively low return on long-term investments assumed here is meant to reflect an after-inflation return, so we're talking real dollars that will buy the same quantity of goods and services decades later.

What $100 grows to at 6% per annum****

	IRA, withdraw after x number of years and pay tax				Capital gains, sell after x number of years and pay tax				Savings account outside IRA, pay tax yearly			
Tax Bracket:	17%	22%	32%	42%	17%	22%	32%	42%	17%	22%	32%	42%
Start with:*	$100	$100	$100	$100	$83*	$78	$68	$58	$83	$78	$68	$58
10 years	$149**	$140	$122	$104	$143***	$133	$113	$94	$135	$123	$102	$82
20 years	$266	$250	$218	$186	$250	$231	$194	$159	$220	$195	$152	$115
30 years	$476	$447	$390	$333	$444	$407	$338	$275	$359	$309	$227	$163
40 years	$854	$802	$700	$597	$788	$717	$599	$483	$584	$490	$339	$230

* You've got $100 working for you inside the IRA. Outside, however, you begin with after-tax dollars.

** Example of calculation for IRA columns: $100 grows tax-free to $179 after 10 years at 6%. Pay tax on the $179 at 17% and net $149. By the way, given the same set of assumptions, tax is paid up-front with a Roth IRA and you end up with the same amount after tax. For example, $83 in the Roth grows to $149 after 10 years at 6% per annum.

*** Example of calculation for capital gains columns: after earning $100 and paying tax at ordinary rates of 17%, you invest $83 in an asset that grows to $149 at 6% per annum tax-free for 10 years. Tax on the ($149 - $83 =) $66 capital gains, assuming the rate is half the overall ordinary rate (8.5%), is $6. $149 - $6 = $143.

**** There are a number of assumptions that can only be approximated due to the convolutions of the tax code. 1. "Inside IRA" assumes that the full $100 is invested initially. This ignores the fact that retirement plan investments generally don't reduce Social Security tax. IRAs and 401Ks do not, while corporate-paid plans do. 2. "IRA" also assumes the same tax rate upon withdrawal, which may be greater or less than the tax rate saved during years of investment. 3. "Cap gains" assumes a tax only at the end of the period and that it will be half the stated rate. Congress is constantly tinkering with capital gains tax rates, so this is impossible to accurately quantify.

So, if you'd invested $100 in a retirement account, 30 years later you would have been able to buy 3.33 to 4.76 dinners, depending on your tax bracket. Obviously, this is a long time to defer the enjoyment of a dinner out—or the latest fashions, entertainment, or anything else that costs $100. But ask yourself, do I really need to spend that last $100? This is designed to get you to reduce the amount spent, not eliminate it.

And begin saving early

You have an enormous advantage if you begin early. A 25-year old needs to invest only $5,700 per year at an after-tax 6.5% rate of return to accumulate $1 million by the time he's 65. A 35-year-old needs to increase the yearly investment to $11,600. While a 45-year old might be able to muster up the $25,800 he needs to invest to reap the same reward, a 55-year old would be hard-pressed to save the $74,100 needed.

Here's a comparison between an early-bird who saves $1,000 per year for the first 10 years and never again and an early-spender who saves nothing for the first 10 years and then begins his savings program at the same $1,000 per year. Note that the early-bird's net worth is greater than that of the late-saver for over 40 years. Think about how much harder the late-saver must work when he doesn't get his money working for him earlier!

6% growth early start vs. late start

	Early spender		Early (brilliant) investor	
Age	Contribution @ 1,000/year	End-of-period value	Contribution	End-of-period value
20-29	$0	$0	$10,000	$15,762
30-39	$10,000	$15,762	$0	$28,222
40-49	$10,000	$42,200	$0	$50,540
50-59	$10,000	$89,545	$0	$90,520
60-69	$10,000	$174,333	$0	$162,100
Less total invested		$40,000		$10,000
Equals net earned		$124,333		$152,100
Money grew		3-fold		15-fold

The sooner you begin investing, the less hard you and your money must work years later.

Here's another way of looking at this. A 6% return on investment for 40 years yields a net worth over twice that of the same return for just the last 30 of those years, almost five times the value compared with the last 20 and an incredible 13 times the last 10 years of investments. In other words:

- the last 30 years of investment (75% of the total) yields 51% of a full 40 years
- the last 20 years earns only 24% of the full 40 years, while taking 50% of the total investment
- the last 10 years of investing yields only 9% of the total investing program, even though 25% of the total funds were invested in that 10-year period

Growth of an investment of $1,000 per year at 6% compounded

Investments begin in	Total invested by 2048	Grows to this amount by 2048	You invested this much of the total	Yet you end up with this fraction if you wait
2008	$40,000	$174,333	100%	100%
2018	$30,000	$89,545	75%	51%
2028	$20,000	$42,200	50%	24%
2038	$10,000	$15,762	25%	9%

The message should, by now, be obvious: don't wait to begin saving and investing and strive for stability both in growth and in your life. Part 2 will focus on the macroeconomics and politics of savings—just in time for the election.

Aftermath of a Real Estate Bubble: Have We Bottomed?

Back in the ancient days when no one could do anything wrong in real estate—you know, two to three years ago—I predicted a catastrophic collapse in housing prices. I wish I had been wrong. I fear I will be right in predicting that conditions in many areas will worsen into at least 2010.

Early on I had a problem estimating how bad the carnage would be. While in 1989-1990 I gave a narrow range of price drops (30-35% in the San Fernando Valley, which proved dead-on), in 2005 I was unable to do so. On a number of occasions I said 20-50%, a huge range. Near the end of 2007, as I saw the collapse become obvious to even the naysayer, I upped my estimate to 25-80% for California and Florida. However I was still baffled that an enormous range of price drops might occur in fairly tight geographical areas such as Southern California.

Recent research (consisting of a couple of Sundays playing "lookey loo" and some time on Zillow.com) explains the conundrum. The run-up was uneven within areas. Lower priced homes in the San Fernando Valley, for example, appreciated some 450% from 1996 to the top in late 2005-early 2006. This range includes my office-house in Granada Hills, which increased from roughly $132,500 in 1996 to about $600,000 at the bubbly, frothy peak. Mid-range homes appreciated almost 350%. This includes a family home in Northridge (it might be mine), which increased in value from about $235,000 to almost $800,000. An estate property—we'll say Samuel L. Jackson's former home in Encino—increased from about $1.6 million to roughly $4 million at the peak, or a mere 250%.

The fact that the run-up was so disparate, perhaps fueled by more "liar" loans at the bottom end than at the top, could explain why the collapse might be irregular. Indeed entry-level houses have, so far collapsed at a far greater rate than pricier digs. That bottom rung house is already down by about a third (to $400,000), the "family home" is probably down by 22% or so ($625,000) and the estate is perhaps at $3.6 million (current asking price: $3.8 million), for a relatively minor 10% decline (even if the absolute numbers are far greater). This idea appears to apply nationwide, with bubble areas generally collapsing far more than those that experienced relatively stable prices during the late, great housing mania.

A collapse comparison

	Starter home	% increase from '96 or decrease from '05-'06	Family home	% increase from '96 or decrease from '05-'06	Estate home	% increase from '96 or decrease from '05-'06
1995	$132,500		$235,000		$1,600,000	
2005-6	$600,000	+450%	$800,000	+340%	$4,000,000	+250%
2008	$400,000	-33%	$625,000	-22%	$3,600,000	-10%
2010-12	$250-300k	-50 to -60%	$450-500k	-37.5 to -44%	$2.5-$3 mil	-25 to -37%

You'd think that with drops of this magnitude prices would have bottomed, or nearly so. Sorry, but there are several reasons for a continuing downbeat outlook for owners (and a more positive one for tenants and would-be investors).

First, prices haven't yet dropped to fair value in many bubble areas. One way of measuring value is to calculate net rental income as if a home is rented and assume an all-cash purchase. Start with gross income and subtract all expenses. Be sure to include property taxes, maintenance, occasional painting inside and out and long-term obsolescence and replacement of systems. Lower priced homes and condos yielded at least 5% for decades until the 2000s. While using such a measure isn't as accurate for the estate home, the "fair value" of the starter home is clearly in the mid-$300s (say, $360,000) and probably about $550,000 for the family home.

Example:	
Likely rent $2250/month=	$27,000
Less expenses:	
Property tax*	-$4,500
Maintenance**	-$4,000
Insurance	-$500
Equals net rental income	$18,000

What does the price have to drop to in order to yield 5% if net rents are $18,000? Divide $18,000 by .05 = $360,000. Proof: $360,000 x .05 = $18,000

* In California, because purchase price determines the tax, we have to work backwards into this number. The tax on a $360,000 parcel would be approximately $4,500 in many areas.

** Very simplified, maintenance includes gardening and normal repairs, plus amortization of periodic painting, replacement of carpeting and window treatments, along with replacement of systems such as air conditioning and plumbing. This varies by the sort of "extras" the house has (such as a pool), as well as age (new requires far less), square footage and location (cold areas and houses near oceans can add considerably to such costs). This doesn't count vandalism or non-payment of rent by undesirable tenants, although such risks should be factored into the equation.

Second, prices aren't yet "affordable" in the former bubble areas. For decades, median house prices barely exceeded three times median household income. While an argument could be made that four times is ok, current prices are still at least six times median income in California. With lending standards returning to what they were for decades before the 2000s (with a risk of becoming even tighter), prices must return to reality. Making homes artificially "affordable" with fancy loans allowed buyers to bid up prices; the reverse requires that sellers, whether you, me or the bank, drop them.

Third, prices tend to overshoot both to the upside and downside. That's particularly true in a market with foreclosure numbers like we've never before seen and a slew of "option ARMs" (adjustable-rate mortgages that allowed borrowers the "option" of making far lower payments than necessary to amortize the loan) that "re-set" from 2009 through 2011 (which means that payments will be adjusted upwards by enough to begin amortization over the number of years left on the loan). A large portion of these are jumbo loans (those greater than the old Fannie Mae limit of $417,000), which could cause the mid- and upper-range prices to implode to a greater extent than even I forecast. (I'm actually very concerned about the possibility becoming reality.)

The fourth reason is an oddball contrary opinion indicator. When full-page ads tout a particular investment, the safe bet is that we should run the other way. In 2000, full-page ads touted stocks. In 2005 it was real estate. Today it's foreclosure seminars. It's possible that these ads are unwittingly forecasting that this is only the first round of foreclosures: the formerly $500,000 homes foreclosed today at $350,000 will be foreclosed tomorrow at $200,000-250,000. Quite simply, when too many think one thing, money is usually made by betting the opposite. Too many are betting this is the bottom.

A fifth reason suggestive of the idea that there is far more on the downside is the simple fact that the bubble has burst. As I wrote three years ago in these pages, bubbles do not end well and their aftermaths are ugly. If I'm correct that this one will go down in history as the greatest ever, it will be especially awful. Yet, there is a sense of complacency, with too many investors seeming to think that prices are now the bargain of a lifetime and will quickly and suddenly reverse. While the collapse is taking form as the left side of a "V" (the slippery slope of which we're only part way down), real estate bottoms are typically long drawn-out affairs, with a trough appearing more as a saucer-shape than as a "V." The price of that starter home was $145,000 in 1994, $132,500 in 1996 and $160,000 in 1998. There was plenty of time to cherry-pick around that bottom.

Sixth, not enough time has elapsed. The bottom after the 1989 peak occurred in 1994 in Northern California and 1996 in Southern California. This bubble was far larger in magnitude. The latest peak was 2005-2006. Not that history will repeat precisely, but five to seven years out suggests a bottom in 2010-2012. If anything, since the price collapse is already greater, the length of time it takes to reach that low might be longer, or the saucer-shaped bottom might be elongated.

Seventh, an "official" recession hasn't even been identified yet. The early '90s recession ended in 1992 and the bulk of the price collapse in California occurred in 1992-1993. Yes, revised figures may later show that we entered recession in November 2007, but even that augurs a continuing drop through 2009 at the earliest.

Eighth, interest rates could increase, particularly after the election. The dollar cannot continue to be trashed without severe risk of long-term repercussions to our standards of living. Foreign investors will not be content forever investing in dollars nominally yielding 3% while dropping 23% relative to their currencies.

So when is it ok for investors to buy? In my view, when that net yield (gross rents minus all expenses except mortgage divided by current values) increases to 7-8% in urban areas ($220-$260k range for that starter home). If you're a would-be homeowner and you've found a home in which you'd be happy to live for 15 years, I won't argue too vehemently once the price in an urban area is such that it would net 5% on an all cash purchase if the property was a rental. For those in outlying and rural areas, I'd probably increase those figures by as much as 50% (so, 10.5-12% for investors and 7.5% for homeowners).

Bear in mind that different areas will obviously collapse by different amounts and over differing time-frames. However, even I have been a bit surprised at the enormity, speed and breadth of the decline. I didn't think swaths in the mid-section of the country would decline by much if at all; they have. While some of those areas may be closer to a bottom time-wise than many areas in the bubble-states of California, Nevada, Arizona and Florida, the aftermath could be worse than even I think likely.