

Managing Risk & Reward – November 2009

As a former derivatives trader and member of the Chicago Board of Options Exchange (CBOE), Chicago Board of Trade (CBOT), and the Chicago Mercantile Exchange (CME), I wanted to offer some insights on how the most powerful organizations in the world are managing **risk, reward** and **tax obligations** as compared to the average investor. As our global economy shifts into a new cycle, and America's role as world leader comes into question, savvy investors will adjust to this new environment and should not rely on traditional thinking or risk going the way of the dinosaur – and become extinct.

Traditional thinking tells us to diversify our portfolio between domestic & international stocks, mutual funds, ETFs, real estate, bonds, and money market funds. Traditional thinking tells us to maximize our contributions to IRAs, 401ks, defined benefit plans, profit sharing plans, etc. so we can enjoy our tax deduction today, and take our income out during retirement when we will be in a lower tax bracket.

The startling epiphany for anyone who investigates the situation more closely, is that the most successful organizations & institutional investors in the world are not using traditional thinking at all...they are, in fact, using an alternative approach that, at first appears to be counter intuitive.

1. *These institutions are not deferring taxes like the average investor – they are employing an IRC compliant strategy to enjoy a completely tax free retirement.*
2. *These institutions are not riding the stock market rollercoaster up and then back down. They are harnessing the power of the stock market without exposing their assets to downside risk.*

The purpose of this white paper is to examine the details behind **how & why** the decision to utilize this alternative approach has been made by leading organizations such as **Goldman Sachs, JP Morgan** and **Wal-Mart**, just to name a few.

Nobody can argue with the **RESULTS OF INVESTORS USING TRADITIONAL STRATEGIES = 95% of those using traditional thinking have failed to reach their goals. Only 5% are successful using traditional thinking. See below:**

Of those who reach retirement age of 65...

- ***1% will be wealthy and financially free (\$6,000,000 + in invested assets)***
- ***4% will be able to maintain their pre-retirement standard of living (\$1,500,000 - \$3,000,000 in assets)***
- ***5% will be forced to continue working to pay the bills***
- ***54% will require some form of government or family assistance***
- ***36% will be dead having passed on a legacy of scarcity***

THE PROBLEMS WITH TRADITIONAL THINKING:

1. Investors who have followed the 'traditional' rules are not making any forward progress (they are essentially running in place); because they have taken **too much risk** (they have not allocated enough of their portfolio to SAFE MONEY - asset classes that carry guarantees). **Important Note:** *While the economy was expanding over the last 60+ years (since WWII) taking too much risk never proved to be a significant problem, because the economic downturns were relatively short in length. Now that the global economy is beginning to contract, market volatility is on the rise, and we have seen two (2) market crashes of over 50% on the SP500 over the last 9 years; it has become clear that we need to do a better job of mitigating unnecessary risk. We still have not come close to the highs on the NASDAQ that we saw in March of 2000. "Hoping for the markets to come back to their highs" is not a strategy – it is a recipe for failure.*
2. Investors believe that stock market is an excellent place to build wealth on a long-term basis, because we have been taught that the market produces excellent long term returns; but reality shows us that the stock market is an **excellent place for professional traders to catch relatively short swings** in price movement. **Important Note:** *According to a DALBAR Study, Average Investor returns over the last twenty (20) years in the stock market are less than 2.75% per year before fees and taxes. Average Investor returns from over the last ten (10) years = less than 0.75% per year before fees and taxes. The poor performance stems from the fact that investors and fund managers are human and are driven by emotion - typically buying and selling at the worst times. Given the fact that the market corrected over 50% twice in the last decade, and the investor returns are so low, investing in the stock market for the long-term has proven to produce ineffective results at best. THIS IS EXACTLY WHY THE MOST POWERFUL ORGANIZATIONS & INSTITUTIONAL INVESTORS IN THE WORLD DO NOT INVEST IN SHARES OF PUBLICLY TRADED COMPANIES OVER THE LONG TERM.*
3. Investors also realized that when **they got into retirement, they were in the highest tax bracket of their lives**, and they have gotten killed on the taxes from their ERISA-QUALIFIED distributions. Every time an IRA, 401k or Defined Benefit plan doubles in value, the tax liability doubles in value as well. **Important Note:** *Inflation alone can force a retiree to have to access more income from their qualified plans during retirement, which may cause a jump into a new, higher tax bracket. WHEN WE LOOK CLOSELY AT HOW THE MOST AFFLUENT INVESTORS PLAN FOR RETIREMENT, THEY MAXIMIZE THE USE OF TAX-FREE RETIREMENT STRATEGIES, AND AVOID TAXATION (EVEN DEFERRED TAXATION) WHENEVER POSSIBLE.*

4. *The most powerful organizations have access to the best advisors and consultants, who are paid handsomely to design financial solutions that work in every type of economic environment. To find out what they are doing, just follow the money.*

In Simple Terms: because of inadequate planning or lack of good advice, the average investor, successful business owner, and highly paid executive are 1) **taking too much unnecessary risk with their assets** and 2) **paying too much in tax**, especially during their retirement years.

To evaluate if a strategy is working or not: *We must track the results during ideal situations and during stressful situations. We learned a lot by paying attention to which assets maintained their value during the last few market corrections/crashes, and which assets crumbled under the stress. If you were not happy with the performance of your portfolio, you would be wise to upgrade your overall investment strategy.*

ELIMINATING UNNECESSARY MARKET RISK

The average investor simply has too much money invested in volatile assets, like equities, mutual funds, real estate, etc.... When the economy is expanding, these assets appreciate, and when the economy contracts, these assets can lose over 50% of their value, as we have seen with the stock market (SP500 2000- 2002, SP500 2007-2009) and even sections of the real estate markets (parts of Florida, Nevada, Arizona, California 2006-2009). If you had to retire in 2002 or 2009, and you lost over half the value of your portfolio, the only person you would have to blame is yourself. Your advisor was simply doing his job, and he did not know what he did not know. **Important Note:** *The volatility of a fluctuating market will destroy the long-term performance of an investment. If you can mitigate the volatility and increase predictability, the results will dramatically improve.*

When we ask investors, “How much of your portfolio can you afford to lose over the next 3 years?” Many will say that they cannot afford to lose any of it, but they continue to take unnecessary risk because they have been taught that in order to outpace inflation, they have to take risk.

PROBLEMS WITH TRADITIONAL THINKING AND THIS STRATEGY

The 1st Problem is that most investors are allocating too much of their SAFE MONEY to long term holdings in the stock market, which does not work, because of the high volatility, too many uncontrollable risks, and low expected return. Since we do not know when the next market crash will be, and we now can expect at least one or two market crashes per decade, does it make sense to allocate our SAFE MONEY to a vehicle

that barely makes any money over the long term and carries so much risk? **Important Note:** *If you are a professional trader and can make money catching short swings in the stock market, then this is a perfect vehicle for you. Passive investors, who want to use shares of publicly traded companies for long term portfolio growth, will experience inadequate performance (as evidenced by investor returns) due to the market volatility that is outside of anyone's control. A good rule of thumb is to subtract your age from 100, and that is the percentage of your assets that should be at risk (INVESTMENT CAPITAL). The balance should be allocated to SAFE MONEY.*

The 2nd Problem is that most investors are allocating too much of their INVESTMENT CAPITAL (RISKY MONEY) into shares of publicly traded companies, which does not work, because the expected return is too low relative to the risk. *Note: Over the last 20 years average investor returns are below 2.75% per year before taxes and fees and the risk is roughly 50% of the principal. Statistically speaking, investing in the stock market for the long term using a buy and hold strategy has proven to produce yields (on average) that are similar to money market returns, that are lower than the current inflation rate, but carry a lot more risk due to the volatility. Investors getting out of the market during the market lows of 2002 and 2009 were the most recent victims of market volatility – which we can only control when using a 'superior strategy'.*

SOLUTION (SAFE MONEY)

Where do we invest our **SAFE MONEY** (money set aside for retirement that they cannot afford to lose)? Ideal SAFE MONEY solutions should offer a strong promise or guarantee, and this promise should be backed by assets that do not crumble when stress is applied. US Treasuries are safe, but the return after taxes is currently yielding less than 25% of our inflation rate. Certificates of Deposit from strong banks are offering after tax yields of roughly 50% of our current inflation rate, and we have had 73 banks fail during 2009 alone. The safest place to keep money and still be able to yield a return that is at least doubles our current inflation rate is with highly rated insurance carriers – this is where the most powerful organizations & the most sophisticated institutional investors keep their money. **The good news is that we no longer have to sacrifice outstanding returns for safety of principal, because of a powerful strategy.**

There is a way to participate in the volatility of the market and enjoy the upside returns, without exposing the assets to downside risk. The concept is called **Fixed Indexed or Equity Indexed Strategy**. This **superior strategy** has been utilized by the top ¼ of the top 1% of money managers in the world for many years. We recommend that our clients allocate a portion of their **SAFE MONEY** to this strategy, because it protects principal, participates in the market's upside without the downside risk, and creates an outstanding expected return.

The idea is to generate a significant return by investing 94% of your portfolio into a diversified portfolio of highly rated bonds (A+ rated or better. i.e. IBM, Microsoft, Intel bonds) that yields approximately 7% return. This means that at the end of the year, we know that we will have at least 100% of our original principal in tact. This also means that we still have 6% of our original assets to allocate. We will use this 6% to purchase options on the SP500 index, as an example. If the SP500 has a great year, our options will explode in value and will yield a return for our overall portfolio that can be as high as 17% or more. If the SP500 loses value for the year, then those options may go worthless, but we still have our original principal in tact.

This strategy has generated predictable returns between 8% and 12% per year consistently and has proven to earn investors a lot more money, even though it is defensive in nature, than an aggressive (or sloppy) strategy of investing directly the stock market rollercoaster.

The **Fixed Indexed Strategy** can be utilized to build wealth safely inside of a taxed, tax deferred, or even completely tax-free environment. Additionally, there are Internal Revenue Code (IRC) compliant retirement plan structures that can be designed using pre-tax dollars to fund it (from the corporate level), allow the funds to grow tax-deferred using the **Fixed Indexed Strategy**, and access the funds tax free during retirement.

SOLUTION (INVESTMENT CAPITAL)

The risky portion of the financial portfolio should expect to generate at least a double digit return, given the associated risk. Given the fact that the stock market does not offer this type of return over the long term; we must find a superior strategy. There is a way to invest with leading companies in the fastest growing industries without the exposure or risk associated with the stock market and its inherent volatility. DIRECT PARTICIPATION PROGRAMS allow sophisticated investors to invest directly in the leading private companies in the following exciting industries: Assisted Living, Medical Office Space, Oil & Gas, and Timber, just to name a few. These programs eliminate stock market exposure or downside market risk from the equation, and provide outstanding monthly income and growth opportunities. Investors are able to partner with the management teams of these companies, and the investments are backed by the assets of the company. Some of these companies end up going public, which creates an outstanding exit strategy, but going public is not necessary for outstanding performance.

ELIMINATING UNNECESSARY TAXES

Taxes are the number one expense for most high income earners, and many believe that we should just pay the taxes and move on. The tax code is now over 60,000 pages and counting, and the most powerful institutions in the world have been utilizing sophisticated strategies to eliminate unnecessary taxes that most investors can take advantage of themselves.

Why do the strongest financial institutions in the world keep between 25% and 50% of their SAFE MONEY inside investment grade life insurance contracts*? Because insurance companies provide a platform that offers an **incomparable combination of liquidity, safety of principal, rate of return, and tax-free access to growth**, when properly structured. Placing SAFE MONEY inside of a properly structured investment-grade life insurance policy creates two (2) assets: 1) Principal Protected Cash Value and 2) Guaranteed Death Benefit. The cash value grows tax deferred, can be accessed tax free using zero-cost loans, and those loans will be paid off by the guaranteed death benefits.

***Important Note:** Investment grade life insurance means that **the minimum death benefit was purchased with the maximum amount of cash allowed, under IRS guidelines**. When **the cost of insurance is minimized** using this method of accounting, the cash value inside of the life insurance contract begins to perform like an investment, earning up to 16% or 17% per year with a 3% floor (depending on the investment choice), and ZERO tax will be paid on the earnings or growth of this account. Banks and sophisticated investors typically choose investments with principal guarantees offered by 100+ year old insurance companies, and return from 8% to 12% per year, tax free.

Bank Owned Life Insurance (BOLI), Corporate Owned Life Insurance (COLI), Trust Owned Life Insurance (TOLI), and Capital Split Dollar (CSD) have been used by large corporations and their executives since 1981, when the Universal Life contract was originally developed by E.F. Hutton. Section 7702(e) of the IRS tax code provides guidance as to how one can borrow earnings out of a life insurance contract using zero cost loans, and loans are of course, not taxable events.

Important Note: The Cost of Life Insurance (COI) is typically around 1/4 (or as much as 1/3) of the cost of otherwise payable taxes (on a similar investment), assuming the Insured is in relatively good health & keeps the policy for at least 20 years, the policy is maximum funded, Fixed Indexed crediting is used, and the Insured is in at least a 25% tax bracket.

Logic: **Instead of paying taxes on their investments, corporations save those taxes, and use a portion (approximately ¼) of the savings to pay for Life Insurance** on their Key Employees – taking advantage of one of the only guarantees in life: death. They fund the contracts using their tax deductible debt, so they receive tax deductible contributions, tax deferred growth, & tax free access. **What would you rather do: pay**

taxes or use a portion (1/4 to 1/3) of the otherwise payable taxes to purchase life insurance? Taxes and life insurance are both costs, even though the life insurance cost of a maximum funded contract is 4 times cheaper. What is important to consider is that you can borrow against the life insurance using zero-cost loans and allow the guaranteed death benefit to pay off all of the loans when the insured passes away. You can also sell your own death benefit to a global pool of investors, many of whom are banks. Furthermore, you can use the death benefit to conveniently transfer wealth tax free. Therefore, every penny of cost that goes to pay for the life insurance is recovered, unlike the cost of taxes or management fees (which are lost forever).

Source: US Government Report: Testimony before the Committee on Finance, United States Senate. October 23, 2003.

Page 10 of this report: <http://www.gao.gov/new.items/d04191t.pdf>

IMPORTANT FACTS

- **467 Banks keep at least 25%** of their tier 1 capital (SAFE MONEY) wrapped inside of investment grade life insurance contracts.
- **58 Banks keep at least 40%** of tier 1 capital wrapped inside of investment grade life insurance contracts, in order to obtain tax free growth and access of funds.
- **3391 Banks** utilize BOLI (Bank Owned Life Insurance) as their preferred investment vehicle for tier one capital.
- **75+% of Fortune 1000** companies use COLI (Corporate Owned Life Insurance) as the preferred vehicle for their retirement planning, **while only 28% still use Mutual Funds.**
- **80+% of Banks with over 100 Billion in assets** utilize BOLI as their preferred vehicle for storing tier 1 capital.
- **Insurance companies have always made good on their promises**, even if they went out of business...going back over 150 years. Nobody has ever reported losing money when buying a fixed product (annuity of life insurance) from an insurance carrier licensed to do business in the US, because of the many safeguards in place.

CORPORATIONS WHO USE INVESTMENT GRADE LIFE INSURANCE CONTRACTS TO STORE THEIR SAFE MONEY (COLI & BOLI)

1. Wachovia Bank owns over \$20 Billion in Life Insurance on its employees.
2. Wal-Mart owns life insurance on over 350,000 of its current and former employees.
3. Bank of America obtains \$570 MM in revenue and \$196 million Net Profit/Year from \$9.5 Billion wrapped in Life Insurance contracts (2001)

4. Prudential, MetLife, Hartford, Amerus Group, AIG, Pacific Life (Insurance Companies) own thousands of policies on their own employees, which they continue to purchase from competing insurance carriers.
5. KeyCorp has over \$8 Billion in Life Insurance (1998)
6. JP Morgan, Goldman Sachs, Walt Disney, Proctor & Gamble, AT&T, Nestle, & Dow Chemical reported significant holdings of Life Insurance contracts.

WHAT WE HAVE LEARNED

1. Stock market investors have been earning less than 2.75% per year over the last 20 years and less than .75% per year over the last 10 years, according to a DALBAR Study.
2. Bankers and financiers are willing to lend, those of us with good credit, money to own strong assets like: real estate & life insurance, not shares of publicly traded companies – which offer no principal protection or guarantees.
3. **Investment Grade Life Insurance Contract (maximum funded policy) is really two (2) separate assets:**
 - a. Principal Protected Cash Value that participates in either interest rate crediting or linked to a stock market index**
 - b. Guaranteed Death Benefit, which is paid for by a small portion of the tax free earnings of the Cash Value.
4. Policy owners can use zero-cost loans to borrow out the earnings inside of a life insurance policy and allow the death benefit to pay back the zero-cost loans.
5. Policy owners can sell their life policies in the secondary market, called Life Settlements, and recover a significant portion of their life insurance costs. In certain situations, it is possible to purchase a life insurance policy and sell it for a net profit, enjoying coverage over the duration.
6. The smartest, most powerful institutions in the world trust insurance companies to store their SAFE MONEY. If they use maximum funded life insurance policies as the platform: **the money is liquid, principal guaranteed, and grows TAX-FREE via two (2) recommended choices of account crediting:**
 - a. Fixed Returns (Approximately 5%/yr)
 - b. Equity Indexed* Returns (9.71% average yearly return from 2700 various scenarios from 1951 to 2005).

**Equity indexed means that the return will be linked to the performance of the stock market, in this case the SP 500 Index. The cash accumulation account inside of bucket will be credited no less than 1% in down markets and no more than 17% in up markets. It is possible to create a floor of 2%, 3%, or 4% by allocating a portion to the fixed account. For a healthy non-smoker, the cost of insurance (COI) can be reduced to 1% per year by closely following TEFRA, DEFRA, TAMRA provisions of the IRS Tax code, which were passed in the 1980s in an attempt to make the Universal Life buckets less attractive for investors