Wealth & Wisdom
INSTITUTE

ELIMINATING LOSING FINANCIAL STRATEGIES

The Defining Moment
A Life-Changing Approach to How Money Works

Prosperity Intelligence
2118 Wilshire Blvd #1141
Santa Monica, CA
Ph 310 587-1959
www.prosperityintelligence.net
www.wealthandwisdominc.com

Prosperity Intelligence

WEALTH AND WISDOM WITHIN REACH

www.ProsperityIntelligence.net

info@ProsperityIntelligence.net

mail- 2118 Wilshire Blvd. #1141
Santa Monica, CA 90403
(310) 587-1959

Defining Moment #1

Your Money Will Never Be Worth More than It Is Today.

Every financial institution understands the power of money. They also understand the term “the velocity of money.” Money that doesn’t move or have velocity is like money that is stuffed in a mattress; it doesn’t create wealth or profits. To give you an example, the average bank in the United States spends a dollar about five and a half times. They take money, and it is not even their money, that is deposited in their bank and lend it to other people. These people who borrowed the money make payments back to the bank and pay interest. The bank then takes those monthly payments and lends that money out again, over and over. This process continues repetitively about five times on each dollar they touch. The collection of interest alone is very profitable for the bank. But they understand one rule that creates more profit for them than just collecting interest. They understand that MONEY WILL NEVER BE WORTH MORE THAN IT IS TODAY. Due to inflation the buying power of a dollar decreases over time. The buying power of $1,000.00 today with a 3% inflation factor built in will have the buying power of only $412.00 in 30 years. The banks and lending institutions understand this clearly. They may even encourage you to make additional monthly payments on the money they lent you. The banks are in a win-win situation. If you don’t make additional payments they will collect more interest over time. If you do make additional payments they will take that money and spend it five and a half times thus increasing their profits. Money will never be worth more than it is today.

If we apply this defining moment to our everyday lives the lesson becomes more apparent. According to the Government Accountability Office (GAO) and David Walker[1], the Comptroller General of the United States, American households have spent more money than they took home the first time since 1934, during The Great Depression (footnote David Walker 6/30/07). The average American’s ability to hang on to today’s money, the money that has the most buying power, is being sent to someone else in the form of debt payments. A greater number of Americans are becoming more

[1] David Walker 6/30/2007

deeply concerned about the increasing costs of health care, housing, taxes, energy cost and rising college tuition for their children. The average Americans find themselves in the dilemma of caring for their children and caring for their aging parents. The ability for Americans to save "today's" dollars has all but diminished. The traditional approach to family financial affairs cannot continue down the same path. It must change, and the sooner the better. What is really needed is more financial literacy. Our government should not be expected to take an active role in addressing family fiscal problems. Typically the government does not respond to problems until they reach crisis proportions.

It is important to understand that "your money will never be worth more than it is today", is a defining moment in itself. Yet it will impact the other nine defining moments that we will discuss. But alone, by itself, let's talk about this and how it may impact your thought process in your everyday life.

Inflation

I remember when I was younger pulling into a gas station in my two-ton '59 Ford and purchasing gas for 19 cents a gallon. If that is not amazing enough, an attendant would come out and pump the gas for me, check my oil, clean my windshield and then politely thank me for my two dollar purchase. There is a lesson there. Not only has inflation adjusted the price of things we purchase today but on a second front, it has diminished customer service, professionalism and direct customer contact. Our society changed in the 1960's and we created a whole generation of "What's in it for me" and "I want it now" folks. Companies marketing to this group focused on "making it faster" and "making it cheaper." In the 70's we lived the lesson of inflation first hand. Mortgage and interest rates skyrocketed into the 20% range and political leadership declined. We learned the hard way inflation has a direct correlation to the buying power of our future dollars. Unfortunately this caused more Americans at that time to become more dependent on government programs and this created another cycle of costs that was passed on to the taxpayer. What we must understand is that inflation is a double-edged sword. It creates higher prices (less buying power per dollar) and fewer services (pumping your own gas).

Let's take a look at an example of how inflation can eat away at your buying power. A thousand dollars today with a three percent inflation rate calculated per year will have only $744.00 dollars of buying power in ten years. This means you will need $1,344.00 in ten years to have the same buying power of $1,000.00 today. In 20 years at 3% inflation that $1,000.00 will have only $554.00 of buying power and in 30 years only $412.00. In that 30th year you will need $2,427.00 to have the same buying power as $1,000.00 today. Inflation should be an informed concern of every American because it will impact their everyday lives.

We should also be concerned about inflation at another level. The debit level of the Federal Government is in the nine trillion dollar range. At current interest rates the government is paying about $41 million dollars an hour just on the interest on its debt. That is $690,000.00 a minute, $11,500.00 per second just in interest. Most of this debt is owned by foreign nations and if interest rates go up, as a country we are in trouble. David Walker, the Comptroller General of the United States, alluded to this on his website and said, "The United States is on a burning platform with no exit strategies." He went on to say, "The status quo is not an option. We face large and growing structural deficits largely due to known demographic trends." Furthermore, he stated that "To balance the government budget by 2040 may require cutting the total federal budget by 60% or raising federal taxes to two times today's level."[2] These are not good options that will undoubtedly direct more of your future dollars away from you, your family and more toward the Federal Government.

If you own a home and have a mortgage on it you are probably the proud recipient of a lot of junk mail. Much of this mail is from financial institutions who want to inform you that making additional payments on your mortgage is a good thing. For whom it is a good thing is not clear. So let me ask you one question. Would you like to make more house payments now with dollars will never be worth more than they are today? If your mortgage payment is $1,000.00 per month, do you want make more payments now when your money has the buying power of $1,000.00 or make more payments later when the buying power of that money is $412.00 thirty years from

[2] David Walker Website 7/16/2007 – Saving Our Future Requires Tough Choices Today

now ($1,000.00, 3% inflation rate for 30 years)? What you need to understand is that the value of your home is going to go up or down no matter what your monthly payment is. I want to live in the nicest house I can with the least amount of monthly payment in today's dollars. By making additional payments or paying cash up front for my house, I have used the most expensive buying power dollars I could to do this. At the same time by using today's money to make additional payments I have made the banks and mortgage companies very happy. Remember they are in a win-win situation.

SEM

There may be times in our lives when it would make sense to fund the things we want in life with someone else's money (SEM) i.e., banks, credit card companies, mortgage companies or financial institutions. We do this all the time with our homes, cars and education costs. The reality is that if we do this we are going to have to pay a premium (interest) to someone for the use of their money. There are good ways and there are wrong ways to use someone else's money in your life. For many Americans it has become too easy to use someone else's money for the wrong reasons. Today some Americans are drowning in monthly payments for the luxury of using this type of money. I do see a purpose for using someone else's money (SEM) when it involves reasonable interest rates, a long-term commitment and a hard asset, such as a house or other real estate, as collateral.

Velocity of Money

If you were to dig a hole in your backyard and bury ten thousand dollars in it and cover it up, what would happen? Ten years later you could dig it up and you would still have ten thousand dollars in currency, but that money would have less buying power than it did ten years ago. Money sitting still by itself, with no movement, gains nothing. Velocity of Money should also not be confused with investing money, such as in stocks, bonds or mutual funds. In investing the hope is that your money will increase in volume. If you continually get positive rates of return from investing in the market, that growth in your money could offset the decreasing buying power and future taxes that you will be facing in the future. It is always good to remember that in investing the only person at risk of losing is you. You will always be approached by people promising you higher rates of return. Ask yourself, who is at risk you or the person making the recommendations?

So what is the Velocity of Money? Let's use an example of a bank. Typically a bank will spend one dollar about five and a half times. They will take money from savings accounts and CD's and lend that money to someone else. The person who borrowed the money pays the bank back plus interest. The bank takes the payment they received from that loan and they lend it to someone else. Now the bank has two monthly payments coming in, plus interest and they lend that money out again. This process goes on about five and one half times. They have created the Velocity of Money that can cycle a dollar through this process many times. We need to pay attention to the fact that the banks have accomplished this feat without using any of their money but rather by using the money that we deposited in their bank.

By understanding how a bank creates the velocity of money, it becomes clear why banks and lending institutions urge you to make additional monthly payments. These businesses understand one thing, that money will never be worth more than it is today (buying power) and the faster money comes in the faster they can spend it five and a half times. Much of the marketing from these companies emphasize the importance of paying off your loans as soon as you can. Everyone would love to be debt-free but at what cost to our buying power? The banks and lending institutions clearly understand that money will never be worth more than it is today due to inflation and the velocity of money creates wealth for them. They are in a win-win situation. They can collect money from you via extra or additional loan payments and spend that money faster or collect interest and principle payments as they come due. Having the ability to spend a dollar more than once is the definition of velocity of money. Once again, this is different than getting a rate of return on your money.

In my travels across the country I have had the opportunity to discuss "the velocity of money" with thousands of people. As always, the goal of these discussions is to encourage people to think, not simply to be told what to think. Being told what to think is void of ideas and creativity. Many times I like to engage people in things that they need to understand so I walk them through a lesson in life and the velocity of money.

If I am addressing a group of people I will ask someone to lend me twenty dollars. Someone is always kind enough to oblige me and I tell the rest of the people to get out their wallets and purses because we are going to play an exciting game. I will hold up the twenty dollars I have just borrowed and sell it to the first person who can give me a ten dollar bill. This exchange usually happens rather quickly. I ask the person who just purchased a twenty dollar bill for a ten, “How do you feel?” Their response is usually favorable. Now I am holding a ten dollar bill and I say I would like to sell the ten dollars for a five dollar bill. This trade also takes little or no time to accomplish. I ask that person how they feel. They typically feel pretty good also. Now I want to sell the five dollar bill I have from that transaction for a one dollar bill. This happens quickly because everyone is beginning to learn how the game works. I am left holding a one dollar bill and I ask, “Now that you know how to play the game, I have a pocket full of twenty dollar bills, do you want to play again?” Of course everyone wants to play again because now they understand how to play the game. I take the one dollar bill I have left and return it to the person I borrowed the twenty dollars from and ask them how they feel. Not so good, right? I note that I gained three new friends at the expense of one. Now I ask, “Where is our big winner?” Usually the person who bought the twenty dollars for ten dollars jumps up. Wrong! You see he did well but only doubled his money, the person who paid one dollar for five dollars did much better, five times what they paid out.

What is more important in this lesson is that three people learned how it felt to be the bank, buying and selling money. They all felt pretty good and made good money. They all realized it was easy to do once they knew how to do it. They all wanted to be in the banking business now. On the surface, they all understood the lesson I presented but I need to take them a layer deeper in their thought process. What is really going on is that the banks and lending institutions are distributing thirty five dollars (a twenty, a ten and a five) for nineteen dollars (twenty dollar borrowed and had one dollar left) and they are collecting interest on the thirty five dollars from the twenty dollars that was not theirs in the first place. They have created something out of nothing. The velocity of money and interest collected pays for the nineteen dollars they borrowed and much, much more. Every dollar collected by a bank has a future value attached to it.

Unfortunately most of us are caught up in the other side of their game of paying interest. Unknowingly, many people are so caught up in debt and interest payments that it is ruining their lives. Their ability to use “today’s” dollars that have the most buying power is gone because those dollars are going to someone else.

LUC

Another aspect of this lesson is that the people who had Liquidity, Use and Control (LUC) of their money were able to take advantage of an opportunity when it came along. They had the money to buy the twenty dollars for ten, ten dollars for five and the five dollars for one. All too often people have all their money tied up in other areas. They have prepaid this or over funded that, to a point where if they need money for a real opportunity, they can’t get to their money. Ask yourself a question, “How often does opportunity knock and how long will it wait for you?”

LOC

As for the poor person I borrowed the twenty dollars from, he suffered a “lost opportunity cost.” Not only did he lose nineteen of today’s dollars but also the ability to earn money from the nineteen dollars forever. On a daily basis many people give away a lot of their money unknowingly and unnecessarily. This problem is compound when they also lose the ability to earn money on that money and negates any opportunity to create velocity of money.

Defining Moment #2

This May Be the Lowest Tax Bracket You Will Ever Be In.

"We are heading for a future where we will have to double federal taxes or cut federal spending by 60%"

-David Walker, Comptroller General of the United States

The rapidly changing demographics of our country are going to impact everyone's lives in our nation. It can no longer be expected that the United States can dictate from the pulpit the direction and course of the world as a whole. Simply believing we are a great nation will not continue to make us one. To compete and survive we will have to change and that change may not come easy. We may have to rid ourselves of some of our contempt, political self-righteousness, and the need to blame someone for our lack of competition in a global economy. Although the United States will remain a powerful nation our ability to change will be our measuring stick in the future.

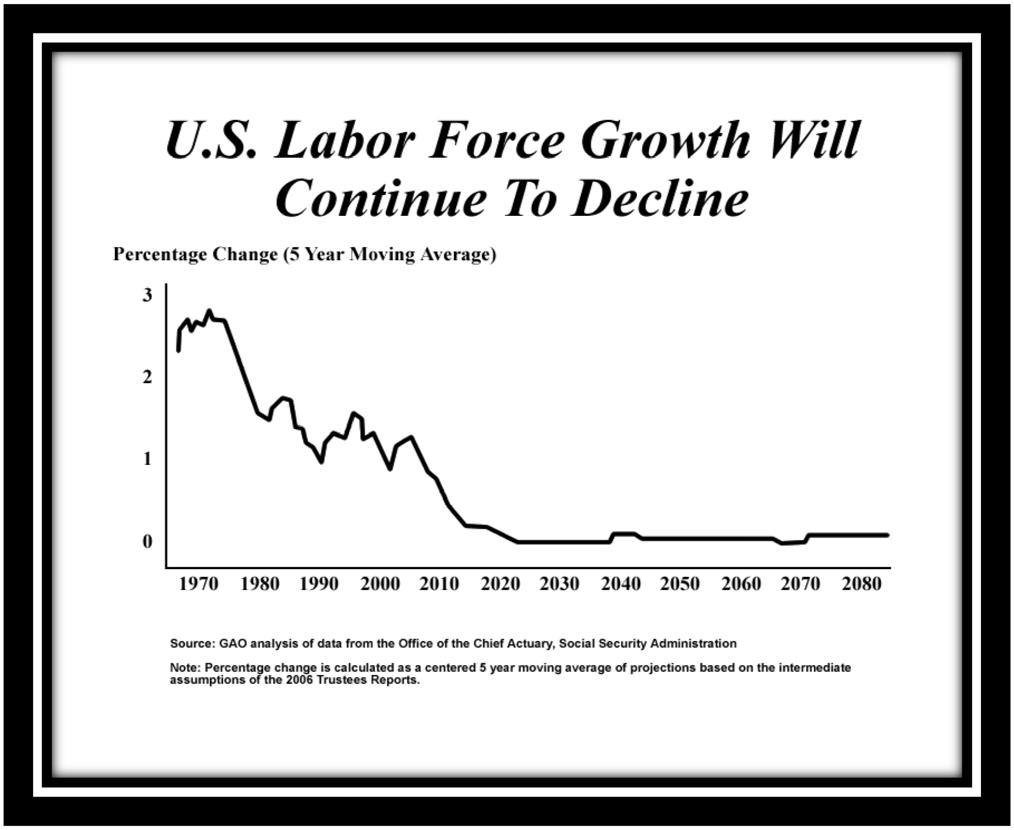
"As a nation we have already made promises to coming generations of retirees that we will be unable to fulfill."

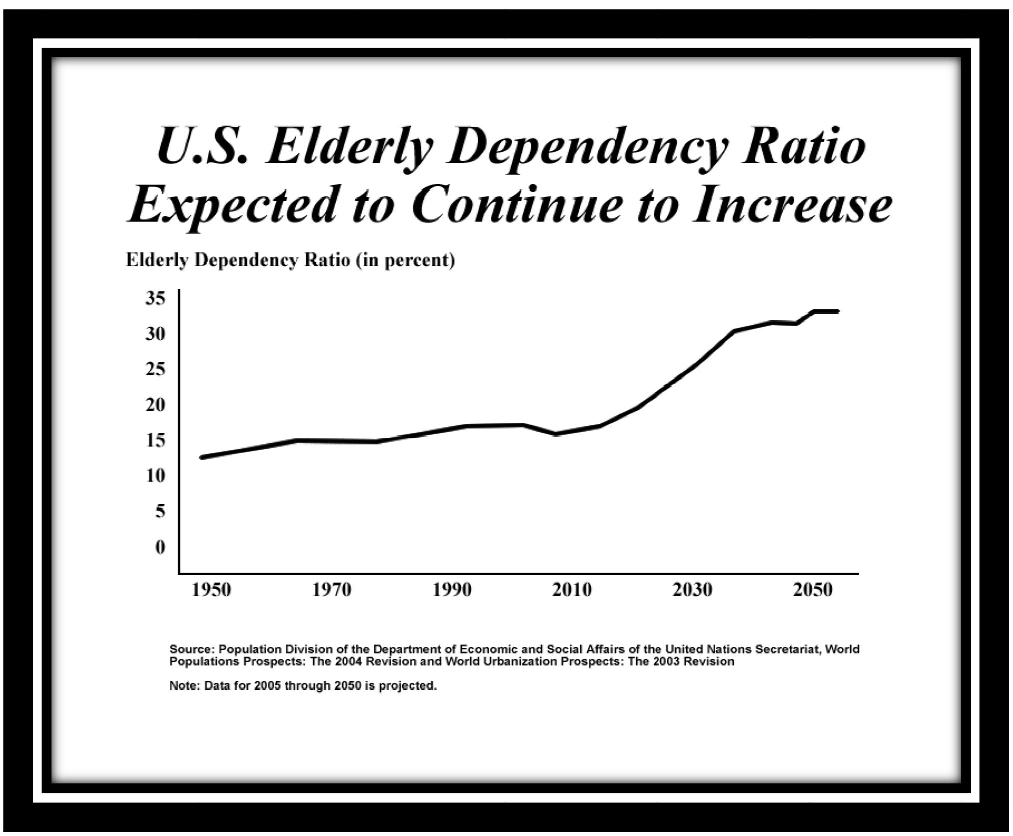
-Alan Greenspan

As you are reading these words the U.S. Federal Government is continuing to spend $1.35 for every dollar it takes in from tax revenues. The debt in our nation is growing at one million dollars an hour, six hundred and ninety thousand dollars a minute and that is just the interest on that debt. According to the Government Accountability Office (GAO) the Federal Government fiscal burden in the year 2000 was $20.4 trillion dollars. Today that burden has expanded to nearly $50 trillion dollars. What does that mean to every person in the United States? Well, in order to pay for this government burden every person in the country would have to pay about $156,000.00. For every full-time worker that comes to around

$375,000.00 or for every household $411,000.00. The purpose of telling you this is not to scare you but rather to make you aware that all the conditions are in place for everyone's taxes to increase. Traditional thinking professionals may be willing to avoid this problem that is out there right now until it becomes a crisis for you. Then it is simply too late to react to the problem.

Future taxes that you pay will be one of the largest transfers of your money that you will ever make. The size and amount of future taxes has not yet been determined but we do know that government debt will be a large determining factor. Another issue in the future tax equation is that the labor force in the United States will continue to decline. We already know that from a percentage standpoint, there will be fewer taxpaying workers than there are retirees who are and will be on government programs (Social Security, Medicare, Medicaid, etc.) and they will be living longer.


U.S. Labor Force Growth Will Continue To Decline
Percentage Change (5 Year Moving Average)
3
2
1
0
1970 1980 1990 2000 2010 2020 2030 2040 2050 2060 2070 2080
Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration
Note: Percentage change is calculated as a centered 5 year moving average of projections based on the intermediate assumptions of the 2006 Trustees Reports.

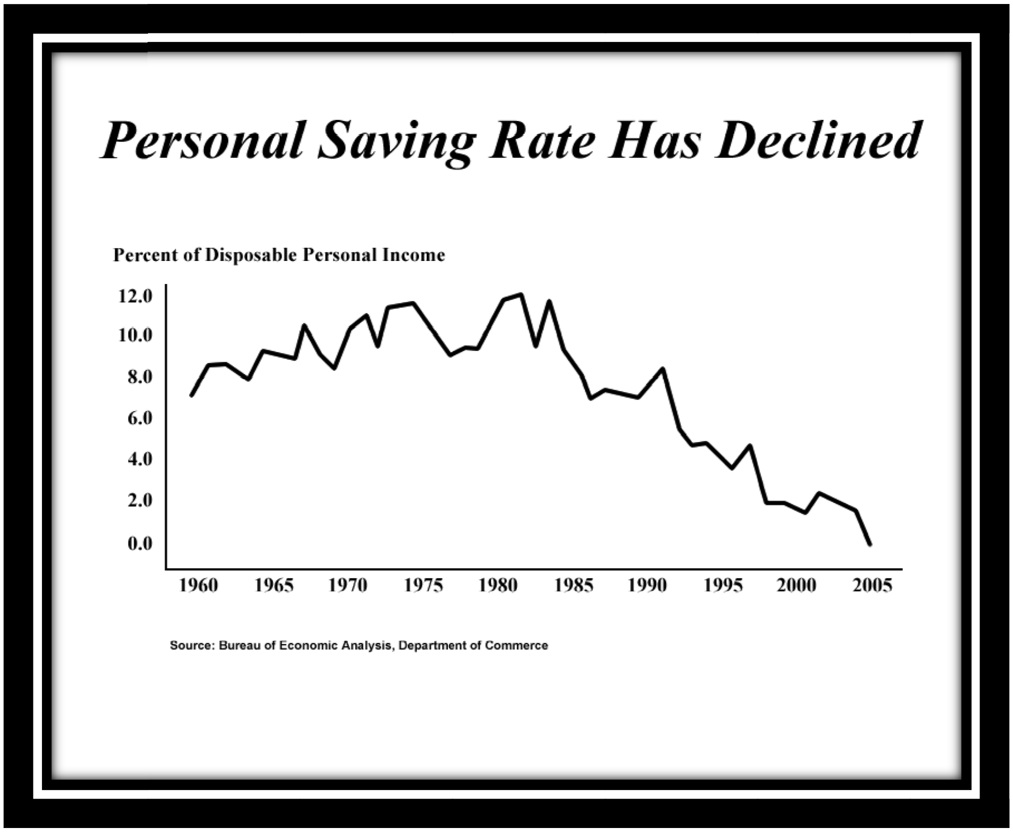

U.S. Elderly Dependency Ratio Expected to Continue to Increase
Elderly Dependency Ratio (in percent)
35
30
25
20
15
10
5
0
1950 1970 1990 2010 2030 2050
Source: Population Division of the Department of Economic and Social Affairs of the United Nations Secretariat, World Populations Prospects: The 2004 Revision and World Urbanization Prospects: The 2003 Revision
Note: Data for 2005 through 2050 is projected.

So let's do the math. We have a declining workforce in the United States. We have an aging population living longer on government programs. We have a government that spends $1.35 for every dollar of revenue they take in. We have $50 trillion dollars in future government fiscal burdens. Unfortunately the only source of revenue for the Federal Government comes from collecting taxes. From the government's standpoint, do you think they are going to lower taxes or raise taxes, increase or decrease government benefits?

"Closing the long-term fiscal gap would require real average annual economic growth in the double digit range every year for the next 75 years. The U.S. economy grew an average 3.2 percent in the 1990's."

-David Walker, Comptroller General of the United States

Imagine now, if you can, your future savings and retirement money being taxed at two times today's levels. Once again this is an estimate from the government's GAO. Traditional thinkers and the so called experts from the government are now telling us that in order to survive in the future where we will all be living longer we must save more money now. I imagine if I could spend $1.35 for every dollar I get like the government does, I'd be ok. But I can't. From the government's own study it reveals that the personal savings rate in the U.S. has declined. In fact this is the least amount of personal savings recorded since 1934, during The Great Depression. The idea of someone saving more now so they can pay higher taxes in the future is a game I do not necessarily want to play.



You may experience a defining moment in your thinking by answering this question. If given a choice would you want to receive money now, when taxes are the lowest, or later when taxes may be much higher? If you are successful and are saving money and deferring the taxes to a later date, you may want to rethink the dilemma awaiting you. The old adage "You will probably retire to two-thirds of your income thus be in a lower tax bracket" may be floating around in your mind. Think! That thought is saying I want less money so I don't have to pay as much in taxes. That is not a great solution but that comment has become so commonplace in traditional thinking it somehow magically became acceptable. Do you want to retire to the least amount of money or the most?

"We face large and growing structural deficits largely due to known demographic trends. Our current fiscal policy is unsustainable."

-David Walker, Comptroller General of the United States

The demographic shifts in our country will impact all of us personally. Not only will the cost of living continue to increase but also the cost of our Federal Government. It is projected that an average 45 year old couple will receive benefits from the government totaling $884,000.00, 45% more than today. The government has created a social dependency problem that has a need and addiction equal to that of a drug addict living on the streets. The government's ability to pay for this addiction depends on us, the tax payer.

"Addressing the nation's transformational challenges may take a generation or more to resolve. Given the size of the projected deficits, the U.S. Government will not be able to grow its way out of this problem-tough choices are required."

-David Walker, Comptroller General of the United States

Understanding the problem that we will all be facing certainly will give you a clearer view to look at decisions you have made in the past and the ones you need to make for the future. Understanding that, at this time in your life, this may be the lowest tax bracket you will ever be in, is important. The government, because of its own actions, is now conceding that taxes must go up in the future. Your ability to accept the idea that taxes will go up in your personal life is not a concession of total defeat, only the concession that it will be a problem and we need to pay attention to it.

The first two defining moments we have discussed so far – *Your money will never be worth more than it is today* and *This may be the lowest tax bracket you will ever be in* - are unique because they will have a direct impact on all the remaining lessons. They also present a very clear challenge to our thought process. Together they question some of the traditional thinking that has been branded into all of us.

If your money will never be worth more than it is today, due to inflation, and this is the lowest tax bracket you will ever be in due to the demographics, why is traditional thinking telling you to take as much of today's money as you can and throw it as far as you can into the future, where it will have less buying power and be taxed the most? Is that the thought-process or type of planning you want to pursue?

When you apply these two lessons to your everyday lives you may perceive things a little differently. If I purchase a car which is a depreciating asset anyway, do I want to use as many of today's dollars that have the most buying power and pay that car off as fast as I can? Do I want to buy that car with the most buying power dollars that I have or the least? I would like to drive the nicest car I can with the least amount of monthly payment. Remember, at 3% inflation $1,000.00 has the buying power of $744.00 in ten years. Would you want to make more mortgage payments on your house with today dollars or more payments ten years from now when the buying power of that payment is less? As discussed earlier, banks and finance companies are well aware that the dollars they get from you and me will never be worth more to them as they are right now. Their marketing may even urge you to make additional loan payments. They know and understand the importance of today's dollars.

These two lessons may also lead you to think about the way you are approaching your retirement dollars. In qualified plans, such as IRA's, 401K's, etc., you must understand that you are simply deferring the tax table to a later date when you take the money out. Whether you retire to a lower or higher tax bracket may depend on how much you are able to save for retirement. One thing is very clear though, because of demographic shifts and the spending of the Federal Government, taxes must go up. 30 or 40% of your retirement dollars could go to just paying taxes. Then you must consider with what you have left after taxes, what will be the buying power of your money at that time? Understanding this may open your eyes to ideas other than today's traditional thinking.

"Tax rate increases of sufficient dimensions to deal with our looming fiscal problems arguably pose significant risks to economic growth. This dramatic demographic change is certain to place enormous demands on our nation's resources."

-Alan Greenspan, Testimony to the U.S. House of Representatives

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