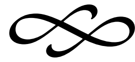
The Pure Investor

The Pure Investor



Howard McEwen, CFA

Copyright © 2003 by Howard McEwen, CFA.

ISBN:	Hardcover	1-4010-8941-0
	Softcover	1-4010-8940-2

All rights reserved. No part of this book may be reproduced or transmitted in any form or by any means, electronic or mechanical, including photocopying, recording, or by any information storage and retrieval system, without permission in writing from the copyright owner.

This book was printed in the United States of America.

To order additional copies of this book, contact:
Xlibris Corporation
1-888-795-4274
www.Xlibris.com
Orders@Xlibris.com
17524

Contents

TUESDAYS WITH THE PURE INVESTOR ... 13
VIEWS OF THE MARKET ... 15
The Politician ... 16
The Chief Executive Officer ... 20
The Church ... 23
The Media ... 25
The Pure Investor ... 27
PROPERTY RIGHTS ... 28
RULE OF LAW ... 30
DEMOCRACY ... 33
THE FIVE TAXES ... 36
Tax One – Direct Taxes ... 37
Tax Two – Trade Restrictions ... 40
Tax Three – Immigration Control ... 44
Tax Four – Regulation ... 45
Tax Five – Inflation ... 47
BEFORE THE PURE INVESTOR ENTERED THE MARKET ... 52
THE PURE INVESTOR STEPS INTO THE MARKET ... 55
WHAT ARE MUTUAL FUNDS ... 59
THE ADVANTAGES OF MUTUAL FUNDS ... 61
THE DISADVANTAGES OF MUTUAL FUNDS ... 63
THE FOUR BOXES ... 65
Box One – Ten-Minute Money ... 66
Box Two – Taxable ... 67

Box Three – Tax Preferred 68
Box Four – Tax Deferred 74
THE PURE INVESTOR
BUILDS A MUTUAL FUND PORTFOLIO 76
Think long-term 82
When to Sell A Mutual Fund 87
Learning from the Pure Investor's Mistakes 89
THE PURE INVESTOR
USES AN INVESTMENT ADVISOR 95
Stop Panic Selling and Fanatical Buying 96
Manage the Manager 97
Manage the Taxes 98
Leverage Other Professionals 99
THE PURE INVESTOR
INTERVIEWS AN INVESTMENT ADVISOR 101
Licenses, Designations, and Experience 102
Fees versus Commissions 104
The Investment Advisor's Practice 105
CONCLUSION 107
SUMMARY 109
SOURCES 119
RECOMMENDED BOOKS
FOR FURTHER READING 125
APPENDIX: TWO E-MAILS
FROM THE SAME CLIENT 127

Dedication

This book is dedicated to my wife, Alicia, who was my primary editor and the first person to believe I could achieve what I wanted. And to my daughters, Dagny and Harper, who thankfully kept interrupting my work so I could play.

ALTHOUGH THE AUTHOR is a comprehensive financial planner and an actively practicing investment advisor, *The Pure Investor* was written for informative purposes only. It should not be taken as a solicitation to become a client of the author or his firm, the Makris Financial Group, Inc. of Cincinnati, Ohio.

I WOULD LIKE to thank Alicia McEwen, Christopher Krafft, Patrick McKinney, and James C. Sexton, III for their help editing and proofreading this book. Without their assistance, it would be a much less clear and typo filled book. I would also like to thank George Makris and Todd Stull for their additional support and insight.

All errors in research, logic, and grammar are my own.

Tuesdays with The Pure Investor

I MET THE Pure Investor as a young man just starting out in the financial services industry. He was older and more experienced. Most importantly, he was generous enough to share with me his beliefs regarding economics, politics, the market, and investing and how each was interconnected. He had a good career and a nice family life. He invited me to his home and shared his food, his wine and his cigars. By all definitions, he was successful. He had an inner calm and stability about him that I was attracted to and wanted to emulate in my own life.

After dinner, over those glasses of wine and through the smoke of those cigars, I would tell him how I felt about this or that subject. He was always quick to tell me not to feel but to think. He guided me through an analysis of each thought and emotion I had regarding economics, politics, and investments. It was a richer education than all my previous study had ever provided. He dramatically altered my beliefs regarding the right way every person should view the financial markets in their own life. He was able to put aside all the societal baggage that weighs down many would-be investors and simply focus on his own

profits and returns. He was able to whittle away any distractions until all that was left was clear, pure investment truth. He was a Pure Investor.

At some point in our discussions, I began to write down his thoughts and observations. I did this mostly to clarify and solidify my own thinking so as a practicing investment advisor I could better communicate with my clients. I saved those yellow legal pads in a drawer that after a few years was overflowing.

I decided that a philosophy this valuable would be useful to others. I asked him if I organized and wrote his thoughts down, would he like to publish this book. For his own reasons, he said no. He didn't explain, but gave permission for me to go ahead with the project. He has read the book and approves of it. These are his thoughts and strategies. He asked that his name not be used so I will refer to him throughout this book as the Pure Investor. I want to thank him now and, after you read this book, I hope you will want to also.

This book discusses how the Pure Investor views the world and what actions he takes to increase his wealth. Specifically, it will concern two areas. First, it examines many of the topics that arise and are debated in each election cycle. It looks at how the broad influences of the church and the media attempt to dictate how the citizen investor should think. It also addresses how businessmen preach false cures for the healthy country that benefit only their companies or their egos. Second, the book prescribes how the Pure Investor should view each of these topics. Those who don't know politics will never know the financial markets. It is important to remember that the first Economics departments at major universities were originally called Political Economy. This book will also gaze into many of the facets of investing that confound many people. Questions such as what and when to invest will be discussed. So to will be how to get professional help. Strict adherence to the positions put forth over the pages of this little book will, over the course of a life, yield a profitable and secure life. This is the ultimate freedom of the Pure Investor.

Views of the Market

THE MOMENT WE are born we receive inputs from society suggesting and, when we fail to listen, demanding how we should behave, how we should think, the attitudes we should have and how to view the world. Many investors intuitively know what is good for their portfolios, but years of guilt and external influences have swayed them from following their natural path. No individual is an exacting capitalist machine. God and salvation, art and literature, beauty and poetry are all passions we hope to include in our lives. However, many of us are unwilling to admit that we will sacrifice these passions within ourselves for profit. The rub is that we don't have to make a choice. Modern society boxes people into categories of artisan or businessman; those interested in only beauty or only profit. The Pure Investor is able to gaze through this static to see the true path to wealth. The Pure Investor has carved away the distractions foisted onto him from the world and in doing so, bettered his life and those around him. He has no interest in giving anything of himself without reward. He also doesn't expect anything without paying the price for it. It is a fact that the efficient allocation of resources demanded by the Pure Investor solves many of the societal ills that the church, government, and charities have repeatedly tried and failed to solve for years. The blowhard politician, the conniving corporate chieftain, the self-righteous bishop, and the

ravenous media are the most pernicious at telling the Pure Investor how to think and act, and what attitudes and opinions to hold.

The Politician

> "The drones of bureaucracy see private enterprise as an old cow to be milked."
>
> Winston Churchill

Many politicians today look at the economy and the financial markets much like Churchill's "drones of bureaucracy" did 60 years ago. They see it as a necessary evil and are constantly looking under every rock and into every university philosophy department for a replacement. Communism imploded, socialism collapsed under its own weight, and the welfare state is rotting from within. Until the time that a replacement is found, the Politician will shackle more and more demands onto free enterprise by demanding that it serve those needs that his constituents believe important. The rugged individualism and self-interested entrepreneurship of capitalism benefits the people more than any of the Politician's taxes and regulations put in place in the name of those same people.

The Pure Investor has no compassion for the citizens ruled by these "drones of bureaucracy." The Politician who does not bend to the prevailing winds are at the mercy of the feckless, short-minded electorate. The people desire a political salve for the minor and major scraps of life in a free, robust country. The salve may anesthetize the wound, but does not heal it. The wound becomes infected and spread until the entire body politic is ill. The Politician is not the problem; he is simply selling what the political marketplace is buying.

The Pure Investor agrees with Groucho Marx's perception that "politics is the art of seeking trouble, finding it everywhere, diagnosing it incorrectly and applying the wrong remedies." A case in point is the Great Depression. According to common, accepted knowledge, the Depression began on October 24, 1929, also known as Black Thursday. This is the day that the Dow Jones Industrial Average (Dow) dropped 12.82%. Within six days of Black Thursday, the market had lost almost

30% of its value. The Pure Investor knows that this is a canard constructed by politicians and those who are suspicious of capitalism. Several factors combined to bring the economic world to its knees, but none of them were a breakdown of the capitalist machine. The stock market is not a thermostat that sets, regulates and controls the economy. It is a thermometer that only measures its temperature.

The first signs of contraction that became the Great Depression began two months before the market crash. The Federal Reserve System, guardian and protector of the nation's money supply, was divided by an internal power struggle between the Federal Reserve Bank in New York and the Federal Reserve Board in Washington. The casualty of this battle was the supply of money held in the country. The Federal Reserve Board, in order to display its new found power over its New York bank, allowed the money supply to fall by one third beginning in late 1929. In effect, for every three paper dollars floating around in the U.S. economy in 1929 one was removed. This induced a massive deflationary recession. Unfortunately, but unrelated, the New York banking system then failed to save the Jewish owned independent Bank of United States. This was the largest bank in history allowed to fail. Many believe it was allowed to fail because of the inherent anti-Semitism of the New York banking establishment. Whatever the reason, the failure of the Bank of United States induced runs on banks across the country. Because of its unfortunate name, many foreign investors thought that the United States itself was insolvent. The public demanded their deposits and bank after bank across the country locked its doors like a tumbling column of dominoes.

Next, Britain left the gold standard. No longer was an English pound backed by a pound's worth of gold. Regrettably, Britain thought having its bureaucrats micromanaging the money supply was the path to improving its own economic situation (The U.S. would take the same regrettable path 40 years later). The Federal Reserve in the U.S. believed that this would cause a drain of the American gold reserves. As an incentive for foreigners to keep their money in the U.S. and having already led the country into a severe recession, the Federal Reserve foolishly raised interest rates. This is equivalent to draining a struggling engine of is oil. The U.S. Congress then helped tip the country and the

world off the precipice by passing the Smoot-Hawley Tariff Act. This placed tariffs on and limited the amount of imports allowed into the country in a misguided attempt to prop up American manufacturing and agriculture. Trading partners retaliated with their own tariffs. A trade war ensued. Each of these factors was an ingredient in a recipe for economic disaster that came together in the early 1930's.

The world stopped.

Originally, the politicians in Congress established the Federal Reserve in response to the banking crises of the 1890's and 1900's. The creation of the Federal Reserve was a political answer to an economic problem. These crises occurred when word would leak out that a bank was having financial difficulties. Nervous depositors would demand their deposits back immediately. When one bank had a run, public confidence in the entire banking system would shudder. This would lead to runs on perfectly solvent banks. A run on a perfectly solvent bank can force it into bankruptcy within days. The answer to these events prior to the creation of the Federal Reserve was for the solvent banks to lend money to the troubled bank before the cancer spread. A more extreme measure would be for a bank to restrict payments to its depositors. This was illustrated in the 1946 film *It's A Wonderful Life* when there was a run on the Bailey Building & Loan. George Bailey, played by Jimmy Stewart, asked all his clients not to take out their money, but take out only what they needed for the next week. He pleaded with them to restrict their own payments. Once mortgage payments and loan repayments started coming in, he could pay off the rest of the depositors if they still wanted their funds. In this way, the Bailey Building and Loan survived. While each of the banking crises was painful to the people involved, each corrected itself. Under the new system, the Federal Reserve System would provide funds to a bank in trouble. Instead of strong banks having to prop up one of its weaker sisters, the government would step in and do the propping. There were to be no more runs on banks or restriction of payments. It was a win-win situation for the banks and for the citizens. Government had solved their problem. It was a Faustian bargain.

The onset of the Depression was the first time in its history that the Fed was tested and it failed. When the Bank of United States began to

collapse the Federal Reserve System didn't provide the liquidity the banking system required. The large, solvent banks didn't step in as they historically had done because they were depending on the Federal Reserve. The political cure for banking crises nearly destroyed the country. Had the laissez-faire doctrine of the first 150 years of the U.S. government been allowed to work itself out, the Great Depression may have only been a severe recession – if that.

The Federal Reserve's lack of response to the banking crisis coupled with its allowing the amount of money in the country to plunge by a third proved that the Fed was not the bank of last resort as intended but was a danger to the entire banking system.

Of course, as the Pure Investor knows, the answer the politicians gave to this massive failure of government was more government in the form of the New Deal. The New Deal was President Roosevelt's massive spending and regulatory program; his counterattack on the Great Depression. Although it was enacted around the time the country's economy was naturally recovering, the New Deal cemented in the minds of subsequent generations the notion that government is needed to protect us from the blows of capitalism.

The Pure Investor knows that government bureaucrats and politicians are too slow, too disparate and too self-interested to react quickly. The politician views himself as standing between the hapless public and malevolent capitalist forces protecting the people with his chosen weapons of regulation and legislation. This interference only delays and garbles the message the market is trying to send to the people making it harder for the people to make the right corrective choices.

A more recent illustration of how government reacts incorrectly or too slowly was the downturn of 2001. This downturn was caused by an inflation-phobic Federal Reserve who had ratcheted up interest rates and contracted the money supply to dampen a supposedly overheating economy without seeing the specter of inflation anywhere. On March 8, 2002, Federal Reserve Chairman Alan Greenspan spoke before the U.S. Senate. He revised earlier testimony given just days before to that body and commented on "an economic expansion already well under way." On the same day the National Bureau of Economic Research issued a statement doubtful if a recession had occurred. If it had, they

reported, it was only because of the September 11th terrorist attacks. Stimulative tax cuts had been passed the previous year and for the most part the economy was recovering. Instead of cheering the news, the politicians tried to cushion the blows of capitalism again. They could not believe the economy could recover without them.

On March 9, 2002, the day after Greenspan spoke, President George W. Bush signed into law an economic "stimulus" package to help the already recovering economy get moving again. It extended health and unemployment benefits to thousands of unemployed workers needed to fill soon-to-be created jobs. The increased spending and accompanying increased government debt soaked up investment funds needed by soon-to-be expanding corporations. It also convinced a certain percentage of the population to delay looking for a job and to keep cashing their government unemployment checks. This "stimulus" package probably prolonged the downturn. Once again the government's fiddling stalled the engine of the capitalist system just as it was beginning to turn over.

The Pure Investor knows that most government policies are a detriment to his profits and returns. He knows that the proposed cures are worse than the disease. He knows that his interests will be sacrificed anytime the mob demands it. After his presidency, Calvin Coolidge stated "Perhaps one of the most important accomplishments of my administration has been minding my own business." Coolidge is the Pure Investor's ideal politician.

The Chief Executive Officer

In 1915, Henry Ford chartered the *SS Oskar II* and set sail for Europe with a group of prominent pacifists. His goal was to land in Europe and explain to the belligerents that fighting World War I was bad. Once he explained this, the nations of Europe would "beat their swords into plowshares" and not "learn war any more." After a life dedicated to mechanical engineering, he decided to apply the same meticulous genius to international diplomacy. The Ford Peace Ship docked in Stockholm in 1916 and when no representatives from the hostile nations decided to attend his conference, he got back on his boat and returned to the United States.

This illustrates a common problem with those who are accomplished in one area. It is that they believe this accomplishment makes them an expert in all areas. The rich too often think their money is a symbol of their intelligence and not a symbol of their hard work, good fortune and expertise in a certain field. There is always a multi-talented singer-actress who decides she must share her thoughts with the United Nations or a comedian who decides to become a political commentator.

However, none of these are so egregious – or dangerous – as the slightly balding, gray-haired, paunch-bellied CEO. Who, through his own talents, those of his employees, and pure good fortune made his company profitable, then decides that his brilliance in management can be applied to politics, economics, and popular culture. Bill Gates of Microsoft, Jack Welch of General Electric, and numerous others have issued proclamations as to how the world should work.

By far, Lee Iacocca, formerly of Chrysler, formerly of Ford, and formerly of a charity to refurbish the Statue of Liberty, has been the most vocal, visible, and didactic polemic. Mr. Iacocca was a good executive who turned Chrysler around after receiving massive loan guarantees from the government. He did introduce the Ford Mustang, one of the most beloved cars of the 1960s. He also introduced the Ford Pinto, one of the most explosive cars of the 1970s. As detailed in *Iacocca: An Autobiography*, his most innovative idea in the automotive field was to create a new car model by bolting on new bodies to existing chassis.

Mr. Iacocca knew all about managing and growing a large car company. He knew nothing about growing an economy or what was good for investors who were not investing in large car companies. In 1984, he wrote his *Iacocca: An Autobiography*. He followed up four years later with *Talking Straight*. The books had chapters with titles such as "Making America Great Again", "Bad Business – What's Wrong with Wall Street", and "Free Trade or Free Ride". In them he argued for higher taxes, restricted trade, required public service and a variety of other dictatorial prescriptions that needed to be taken to prevent the decline of the United States from an indifferent and lazy citizenry from within and Japan, Germany, and other former enemies from without. In his autobiography, Mr. Iacocca ends his preachy chapter "The Japanese Challenge" this way:

> I [Iacocca] don't know when we're going to wake up, but I hope it's soon. Otherwise, within a few years our economic arsenal is going to consist of little more that drive-in banks, hamburger joints, and videogame arcades.
>
> Is that really where we want America to be by the end of the twentieth century?

It must be noted that few if any of his recommendations were executed. However, by the year 2000, Japan was in an economic malaise with its stock markets at a 17-year low and Germany had a case of endemic 10% unemployment. The U.S.A., having mostly ignored his advice, had ended the longest peacetime economic expansion in its history with a mild recession. The United States' technological innovation was spreading across the world and had empowered millions to demand economic and political freedom in their own countries. Iacocca's own firm, Chrysler, was a subsidiary of a German corporation.

By far, the most cynical subterfuge a group of CEOs ever succeeded in perpetrating was after the September 11, 2001 terrorist attacks. Since the 1970s, the chieftains of the airline industry and almost all other industries, were champions of free market capitalism. Like the Pure Investor, they claimed that any intrusion into their business affairs and practices were an intrusion into their freedom and profits.

Following the attacks, the Federal Aviation Administration grounded all flights for 4 days and the amount of passengers wanting to fly severely declined for weeks. Before the debris cleared over lower Manhattan, the airlines threatened massive layoffs. Within a week, representatives from all the major airlines were meeting with the President and the leaders of Congress to arrange loan guarantees, direct cash infusions, and the nationalization of airport security that was a major cost to the airlines.

The question the Pure Investor asks is why did the airlines get special treatment? The financial services industry was clearly devastated by having its main center destroyed. This is comparable to the auto industry having Detroit destroyed. The financial markets were closed for the longest period in their history. The week following the attacks

the Dow Jones Industrial Average fell by 15%. This was on top of the previous year's dramatic percentage decline. Television networks and cable channels also lost tremendous amounts of advertising revenue because of their moral obligation to broadcast 24-hour coverage with no commercial interruptions.

Why did the airlines alone get government handouts? The easiest answer would be that it had the misfortune of being the most visible industrial victim that the country could identify. Primarily however, their trade association lobbyist was the most organized and aggressive. The airline CEOs sold out their free market principals, their customers, and the American people for an opportunistic grab at a bag of cash. No doubt, in time to come, a successful airline CEO will issue his proclamations or write a book on how this world should work. He will not mention he made his company succeed by begging corporate welfare dollars while Manhattan smoldered.

The Pure Investor always analyzes the motives of businessmen. As Adam Smith, the 18th century Scottish political economist stated, "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."

The Church

On April 5, 2001, the National Counsel of Churches issued a statement that concluded, "Let us be clear, we oppose the tax cut proposal initiated by President Bush and currently moving through Congress. It is too inequitable, too large, and threatens the future well being of our nation." The statement was signed by 18 leading Christian and Jewish leaders. Ignoring the specifics of the tax cuts, the signing clergy mistakenly believe that the Robin Hood economics of taxing the rich and giving it to the poor is the way to eliminate poverty and misery. The National Council of Churches is a mainstream organization representing 36 denominations including the National Baptist Convention of America, The Episcopal and Presbyterian Churches, and the Evangelical Lutheran Church in America.

The Pure Investor is not affected by the guilt heaped upon him by

those who do not know how wealth is created. Unfettered, unbound capitalism is the best anti-poverty program available. Capitalism, and the political freedom that always comes with it, is the reason why Cubans cross the Florida Straits, mainlanders swim Deep Water Bay to reach Hong Kong, and East Berliners ran face first into the barbed wired wall separating them from the West.

The tax cut proposal that the National Council of Churches lambasted was passed. Checks began to arrive in the mail. Entrepreneurs kept a larger portion of their earnings and stockholders were rewarded a little more for their risk taking. Employees were able to receive the money as a paycheck and not as a government handout. The country became more profitable and the Pure Investor applauded. Predictably, after invoking the name of "Micah, Amos, Isaiah, and Jesus" and finally "Gandhi", the Council's General Secretary Robert W. Edgar asked, "When you receive your tax rebate check, I hope you will consider sharing all or part of it with the NCCC [*sic*] and/or your state or local Council of Churches." The statement was issued on their website with a convenient link to donate to the council by credit card. On August 28, 2001, the editors of the Wall Street Journal ridiculed the Council. "[The NCC] is asking for you to redirect your rebate to worthier causes such as, er, themselves." The Journal editors continue, "Now, since the rebate checks began arriving in mailboxes, retailers from Wal-Mart to Home Depot have made their own bids for the money. But . . . the Home Depot didn't lobby against your getting the money in the first place."

In 1999, the Evangelical Lutheran Church in America (ELCA) issued "A Social Statement on Economic Life: Sufficient Sustainable Livelihood for All." While it briefly acknowledged that "the current market-based economy does that [meet people's material needs] to an amazing degree." It counters that "others continue to lack what they need for basic subsistence." It then details the poverty and instability of the world's poor and finally calls for several controls to be placed on the world's market-based economies. The ELCA report calls for public and private sector partnerships to create jobs and job retention programs; government to provide adequate income assistance and related services for citizens, documented immigrants and refugees who are unable to provide for their livelihood through employment; appropriate,

government regulatory reform so that government can monitor private sector practices more effectively and efficiently in an ever-changing global economy; and many other policies they wish the government to impose on the economy or corporate America to impose on itself.

The church's deficiency in historical knowledge is criminal. It should be aware that deprivation, starvation, death, and misery have occurred most in countries where market forces have been removed from the economic system and controls have been imposed on the people. The Pure Investor doesn't see a minimum wage as a reemergence of National Socialism, but he does agree that the slow adoption of the policies advocated by the church in their striving for "social justice" is, in the words of Austrian economist Friedrich Hayek, "the road to serfdom." The answer to improving the economic lots of poor families is not to throw over their shoulders the heavy blanket of government protection, but to pull them into the warm embrace of the capitalist system. The Pure Investor doesn't want them protected from the markets, but participating in them.

The church says we should strive for the equality of man. The fashionable church leadership maligns the U.S. as a greedy, unjust, and oppressive country. The Pure Investor looks at the food the United States ships abroad and the technology selfishly developed by our citizens that saves lives of third world people and makes their impoverished life slightly easier and more tolerable. After looking at all this, the Pure Investor must agree with the brilliant Tom Wolfe in his essay "In the Land of the Rococo Marxist" from his book *Hooking Up*. He states, "If you must rate a nation at this moment in history, your accursed America is the very micrometer by which all others should be measured."

The Media

The purpose of broadcasting and printing financial news is the same as that of broadcasting cartoons, sit-coms, and cop shows: to sell advertising. In order to sell advertising, newspaper editors, news anchors, and news radio must get people reading newspapers, eyes watching television and ears listening to radio. The best way to do this is to make the news as dramatic and compelling as possible to the most people.

This is why when the weatherman at the local station gives an off-the-cuff financial report he states that the stock market soared or plummeted when in fact it was just another trading day. If the average person went into an office building and the elevators were not labeled up and down, but soar and plummet, he would take the stairs. However, simply saying that the market went up or down does not sell newspapers or airtime.

This same problem is particularly evident on the financial cable channels such as CNBC and CNNfn. Every announcement, event, and issue that at one time would not have made it onto the evening news or the front page of the Wall Street Journal now gets massive amounts of attention. The event gets hours of air time, its own logo at the top of the screen, and two analysts speaking about how this triviality will effect the markets, the economy and their audience's wealth.

The Pure Investor does not allow these gnats of news to swirl around his brain and distract him from his long-term goal. He finds for himself a reliable news outlet that gives a brief and concise report. He stays informed, but not overloaded with so much information that he is unable to decipher it and make decisions for himself. The Pure Investor makes a habit of reading at least the *What's News* and *Worldwide* columns on the front page of the *Wall Street Journal* and watching the weekly broadcast of *Louis Rukeyser's Wall Street.* These outlets provide an informed, unemotional synopsis of what is important in the business world without dwelling on what is not important. Forbes, Fortune and Business Week are also read to keep up with longer-term issues. The editorial pages of business journals provide opinion about what will be important in the future. The writing in these publications is neutral, if not haltingly positive, and helps maintain a focus on the long-term.

The Pure Investor will always question the media and its motives. Just prior to the outbreak of the Spanish-American War, newspaper illustrator Frederic Remington requested from his boss to return to the States from Havana since it appeared there would be no hostilities. His boss, the newspaper magnate William Randolph Hearst, responded, "Please remain. You furnish the pictures and I'll furnish the war." After a campaign of banner headlines regarding the plight of the Cubans and the cruelty and audacity of the Spanish, America entered the war and newspaper sales rocketed.

Nowadays, with more citizens than ever before investors, every market hiccup is another sinking of the *Maine* and every market rally is another ride up San Juan Hill. The purpose of the media is not to inform but to sell.

The Pure Investor

The Pure Investor views free markets as the end result of Western Civilization's pursuit of freedom in all of its forms. He has the potential to succeed and profit or to fail and lose and the choice to try again. But he must participate; it is not possible to opt out of the system. He can learn how the world works and utilize it for his benefit or rage and struggle against it as unfair, corrupt or unjust. He has no choice but to participate.

A market is only as good as the society it is a part of. A society is like a car. It must have three essential components to make it go in the market: a chassis, wheels, and a motor. In modern society those three components are the commitment to and respect for Property Rights, the absolute and uncompromising adherence to the Rule of Law, and fealty to the people through a Democratically elected government. The best financial plans ever designed were the Declaration of Independence and the United States Constitution. What Jefferson and Madison did in those two documents was to build a vehicle that would take their country and those that followed similar principles on a journey into a future of unprecedented growth and prosperity. It is a wonderful vehicle when pondered. It provided incentives for innovation and invention. Transportation is only one area. The speed at which Jefferson traveled to Philadelphia was the same as that of Jesus traveling to Bethlehem 1,776 years before. But within 200 years of the production of this vehicle call America, men went from riding horsebacks to driving automobiles and then from traveling in locomotives to traveling on airliners. Americans went from the horse stall to Cape Canaveral in a historical blip. Once a few more options were added to the base model of Property Rights, Rule of Law, and Democracy, nothing on the street could beat it. It is, as the English magazine *The Economist* noted in its July 11, 2002 edition, "the most creative, enterprising and productive system ever devised."

Property Rights

MOST AMERICANS TAKE for granted that what is theirs will remain theirs until they decide to sell it. They take for granted their right to enjoy their own property and use it for their own benefit. This was still a rather novel idea at the founding of the United States. Kings had the ultimate rights. Lesser royalty were divested and invested with estates at the whim of the sovereign. Peasants, when they were allowed to own anything, could have it taken without cause by the local prince.

Today, while there are few kings, most of the world lives with dictators and oppressive governments who behave in the same manner as the kings of old but without their sense of *noblesse oblige.* The citizens of these countries will not work and businesses will not invest if any excess can be snatched away by a greedy tyrant. The Pure Investor thinks of the joke common among Russians during the Soviet era, "we pretend to work and they pretend to pay us." Corporations are especially sensitive to any whiff of this. Consider the factories in Cuba that were confiscated when Castro seized power and nationalized all foreign property. This included a Colgate-Palmolive soap and detergent factory, an Owens-Illinois glass and bottle factory, a Freeport-McMoran nickel mine, and an ITT telecommunications facility. These seizures were equivalent to the factories being blown up. No insurance company

covered these losses. What incentive does an entrepreneur in these countries have to build anything for his family or himself when a thug-dictator can seize them at will? A country that guarantees these property rights will prosper and attract individuals who yearn for the assurance that they can keep what they build.

Property rights are what the founders were speaking of in the Declaration of Independence when they referred to “the pursuit of Happiness.” They also dealt with this right in the Preamble to the Constitution. The U.S. government will be charged to “secure the Blessings of Liberty.”

However, the Pure Investor knows that he doesn’t have absolute property rights in this country or other modern western countries. Timber companies have struggled when vast stretches of their inventory cultivated for decades become off limits because a questionable study finds a spotted owl rare. Building contractors that are heavily in debt and whose work schedule is at the whim of the weather have been known to kill all vegetation and wildlife on their properties so the probability of an endangered species being found will diminish. Property owners in Lake Tahoe, looking to build their dream home, have had a legal freeze on new building since 1981 when a “temporary” moratorium on building was imposed to protect the lake against algae growth. In an August 2001 article Casey Jones of the Medill News Service quotes landowner Kenneth Eberle “We’d like them to admit . . . that they can’t just take somebody’s land and make it impossible for them to use it.” Mr. Eberle bought his home in 1977, has paid taxes on it, maintained it, and has been unable to use it. His rights to his property were taken and he has never been compensated.

Every time a government agency or official appropriates or controls a citizen’s property, property rights are eroded. Every time the courts do not act, it emboldens the government. Paul Begala, a senior aid to Bill Clinton once said of executive orders that bypassed Congress and nationalized large portions of western states for the park’s service, “Stroke of the pen, law of the land; kind of cool.”

With a Paul Begala “kind-of-cool” attitude pervading the government, Americans must constantly be on guard. The natural tendency of government is to grow and oppress.

Rule of Law

MARKETS REQUIRE THAT businesses and individuals trust one another. This is accomplished when parties freely enter into contracts to increase their own wealth. But these contracts must be enforceable. When one party breaks it, the aggrieved party should be able to have a place to fairly resolve the dispute. The courts are this place. This not only requires that a country be free of corruption, but that its justice system is strong enough to punish those that break the contract. Only in this environment can the Pure Investor prosper.

For example, when an employment contract is signed, the employer must follow through with whatever wages and benefits were agreed to. Unions must not use the strike option as a blackmail tool to squeeze more concessions out of the company. Labor laws are very specific and detailed. The most dramatic business struggles of the 20th century concerned the Rule of Law between companies and unions. Too often union members see managers and owners as late eighteenth century caricatures of pigs in tuxedos smoking cigars lit by hundred dollar bills. Management has had similar opinion of labor. Nineteenth Century railroad financier Jay Gould said, "I can hire one half of the working class to kill the other." Henry Ford said, "Labor union organizers are the worst pest that ever struck earth." However, if each side is held to the Rule of Law each will benefit in the long-term. The primary purpose of

labor law is to protect the workers and the company from each other. They serve the secondary function as a road map for business planning. If managers decide on option A, they know what the consequences will be and what options they have. Managers can weigh the risks and rewards. Union bosses are able to plan for their workers using the same tool. If either side breaks the law and is not held accountable, then not only their own planning, but also the confidence of other companies and unions in the Rule of Law, is destroyed. When planning can't be done, business is disrupted. President Reagan was protecting the Rule of Law when he fired the air traffic controllers in 1981 for, in his mind, striking illegally.

The Rule of Law is not only important between labor and management but between companies and suppliers and vendors. If contracts can be broken, business cannot plan. They become very shortsighted and do not invest as much for the long-term because investing for the long-term is risky. Instead of investing in things that increase their country's productivity, they invest in the protection rackets offered by politicians who have replaced the Rule of Law. The stock markets smells this unproductive capital being misused and runs away from it, driving down stock prices.

The best example of this is the business scandals of 2001 and 2002. By this time, the market had battled an overly tight Federal Reserve, the collapse of the dot coms, the September 11th terrorist attacks, and the subsequent war in Afghanistan. Corrective actions had been taken and the market seemed poised for recovery. These events, while unforeseeable and devastating, were seen as a risk of doing business. However, the bankruptcy of Enron in November of 2001 and the subsequent uncovering of shifty accounting practices of Arthur Andersen shook the foundation of the financial markets. Similar revelations by Tyco, Adelphia, ImClone, and Worldcom led many investors to believe that something criminal had been occurring and was going unpunished. Investors lost their confidence in the Rule of Law. From November 15, 2001 to July 23, 2002, the Dow Jones Industrial Average dropped 22%, the S&P 500 fell 30%, and the NASDAQ was down 35%. Shares kept dropping as investors punished companies by selling. The money flowed into money markets, bonds or foreign markets. In the minds of investors

it was possible that the risk of investing in the U.S. was equal to that of a third world country where bribes and kickbacks are accepted methods of doing business. The turn around didn't occur until July 24, 2002. That morning, before the markets opened, the 77-year old founding executive of Adelphia Communications and his sons who were also executives in the firm, were arrested, handcuffed, paraded before television cameras, and booked on securities fraud charges. By the closing bell, the Dow Jones jumped 6.4%, the NASDAQ climbed 5%, and the S&P 500 rose 5.7%. Confidence that the Rule of Law was again being enforced attracted investors and their money back into the stock market.

Investors will accept the risk of war, political assassination, the business cycle, and domestic turmoil. Investors will not accept that the system may be rigged against them like a pair of loaded dice. If they smell the slightest whiff of systemic fraud or deceit, they will sell and run.

Democracy

WHERE THERE ARE regular free elections of a country's leaders, there is the rule of law and property rights. Dictators and tyrants first rob the people of their political power and voice and then steal their property and profits, usually in the very name of the people. When Castro came to power in Cuba, he stole everything in the name of the people. The shareholders of many major United States corporations lost millions of dollars in property. Now, few from anywhere in the world will invest in Cuba under Castro's oppressive regime for fear that any profits will be stolen or their property seized. The governments of western nations may give the oppressed citizens in these countries foreign aid and other guarantees, but no businessman is willing to freely invest his own money into Cuba or any other kleptocracy. Castro and his family are rich while the people starve.

The best example of democracy bringing economic growth is the Middle Eastern nations. The only democracy in that region is the state of Israel. This political freedom is reflected in the economic life of Israelis. It's gross domestic product (GDP) – a measure of the total value of all goods and services produced in a country – for the year 2000 was $17,710 per person. The GDP of oil rich aristocratic Saudi Arabia was only $7,534.78 per person in the year 2000. Theocratic Iran's per capita GDP was $1,650 and autocratic Egypt's trailed at $1,540. The GDP of

all the other Middle Eastern nations is similar or too low to be measured. While some may attribute the greater productivity of Israel to U.S. foreign aid or preferential treatment of Western European nations, these benefits are easily outweighed by the constant threat to Israel's borders from its neighbors, its security from within, and its lack of natural resources. The Pure Investor attributes Israel's wealth to the political and economic freedom of its citizens to reap the rewards of their hard work.

Further, the Pure Investor knows that no two democracies have ever gone to war. The great wars of this century have been between countries of democracy and those of tyranny. The United States has never fought another democracy in combat. It was dragged into World War I during the final gagging breaths of that war. France had already been trenched and gassed into a wasteland. Before the U.S. entry into World War II, Hitler had taken Austria, Czechoslovakia, Poland, the Netherlands, Belgium, Norway, and France. London had already been blitzed. In the East, Japan had already run roughshod over most of Asia. The cataclysm of war is a catastrophe to people, economies and businesses alike. Factories, infrastructure, and people are destroyed and unavailable for productive uses. The Pure Investor knows that the common idea that WW II brought the country from depression is a dangerous fallacy. People believe this lie because they reason that the stimulus to the economy of building arms and employing people as soldiers and defense workers will lift up the economy. It is a notion that should be removed from the conscious of the public for fear that policymakers may follow this misguided idea and plunge the country into war during a future economic slowdown.

Waging war is not productive. If it were the case that war could bring a country out of recession, the Pure Investor suggests that countries who would fight each other to spur their economy should do without all the horror and carnage. They shouldn't fire missiles into the air. They could fire Cadillacs, or computers, or furniture. This way they can avoid killing anyone. Using this strategy, soldiers become workers. The economy is lifted and no one gets killed.

No one votes for an aggressive war. No mother votes to send her child to war. A democracy is always hopeful. In the face of war, it

grasps for peace. Democracy should be spread not only for peace but prosperity.

Americans must stand firm for Property Rights, the Rule of Law, and Democracy. In the year 2002, the United States tied for 4th in the Heritage Foundation and the Wall Street Journal's *The Index of Economic Freedom*.

This is an annual survey that ranks a country's economic freedom based on several factors including the pervasiveness of a black market, amount of government regulation, and its fiscal burden. The U.S. was behind New Zealand, Singapore and Hong Kong because these countries allowed their citizens more freedom to succeed and fail. They were much like America was near the turn of the century.

For those who think America will always be a freedom loving people need only review the 1928 United States Socialist Party platform planks. Since that pre-depression era, both Democrats and Republicans have fully or partially implemented each of the planks in this country. In 1962, the Socialist Party's 1928 presidential candidate Norman Thomas said "The difference between Democrats and Republicans is: Democrats have accepted some ideas of Socialism cheerfully, while Republicans have accepted them reluctantly." As each dirigiste Socialist plank was nailed down by the mainstream parties, a small bit of Property Rights, the Rule of Law, and Democracy was extinguished and vibrancy was drained from the economy of the United States of America.

The Five Taxes

PROPERTY RIGHTS, THE Rule of Law, and Democracy are essential ingredients to a fertile environment for investment growth. The extent of taxes in a country, however, can add or detract from that growth. Taxes are inextricably linked to these three ingredients. A tax is the legal taking of someone's rightful property. As a bloated government grows and creates more dependents willing to give up their power, its bureaucrats grab that power to bend and mold the Rule of Law to their own purposes. Aggressive, unbridled taxation can drive an investor class from a thriving democracy with a long history of laws and secure property rights. Most of socialist Europe has been following this path for decades. Its investment atmosphere is stagnant and oppressive.

On the Western fringe of Europe, Ireland has become a beacon to capitalism. It has instituted low taxes, which has induced high foreign investment and low unemployment. Consequently, Ireland is the second largest exporter of computer software after the United States. Other Irish industrial sectors are expanding rapidly as an envious and jealous European Union looks on.

Taxes are not only bad for businesses and employees; they are also a step towards totalitarianism. P.J. O'Rourke, in his book *Parliament of Whores*, proposes that anyone who wants to increase taxes should ask

himself the question, "Would I kill my kindly, gray-haired mother for this?" He explains that "all tax revenue is the result of holding a gun to somebody's head. Not paying taxes is against the law. If you don't pay your taxes, you'll be fined. If you don't pay the fine, you'll be jailed. If you try to escape from jail, you'll be shot."

The Pure Investor defines taxes as any reduction in his worth or income directly caused by the government. The Pure Investor functions best in a capitalist society that allows individuals instead of bureaucrats to control the allocation of resources. The wars of the last half of the twentieth-century were fought over this choice. The United States fought German National Socialists in Europe; it fought Red China in Korea; the Soviet Union in Vietnam, and various other despots in skirmishes around the globe; all of who wished to impose their moral and economic will on an innocent population. The U.S. fought not only to protect its own hegemony in the world but also to allow the citizens of these countries the opportunity for economic freedom.

The Pure Investor knows that it is counterproductive to have a central power deciding who succeeds and who fails, what projects are funded, and what dreams are allowed to be fulfilled. He places his faith, confidence, and trust in the millions of individuals who have the freedom to make much smaller decisions for themselves. In this environment many fail, some succeed, but all are free.

The Pure Investor spoke of five distinct taxes whereby the government has reduced his wealth. Some are blunt and stunt an economy and the investment community. Others are discrete as a leech, only noticed by the lethargy its blood sucking induces. All slowly erode the freedom and productivity of its host country.

Tax One – Direct Taxes

Taxes directly assessed by the government are the most visible and possibly most egregious example of removing money from the productive environment of the private sector and placing it into the control of those who will strangle the growth and the good it could do.

Every year the Tax Foundation, a nonprofit, nonpartisan public research organization, releases a report detailing just how long American's

must work to pay their federal, state, and local taxes. At the height of World War II, the Pure Investor had to work until March 30 to pay the bill for a two-front global war against the superpowers of the day along with the usual administration of a government. As of year-end 2001, the average American works until April 27. Although the U.S. has prospered tremendously, the Pure Investor is crushed by the amount of riches lost because of all of the cash, sweat, and productivity gobbled up by a distended, bureaucratic government.

The Constitution enumerates three specific tasks the government should do. " . . . in Order to form a more perfect Union, establish justice, insure domestic Tranquility, and provide for the common defense." So once the government has set up a court system, a police force, and an army, it should be finished. However, Roosevelt's New Deal of the 1930s followed by Truman's Fair Deal, Kennedy's New Frontier and the welfare state expansion of the late 1960s was justified by the additional clause that stated "to promote the general Welfare." The Pure Investor needs only to walk through once proud old inner city neighborhoods that have the look of a battlefield and are filled with families who have spent generations on welfare to know the cost of Johnson's "Great Society." It has not only been a waste of valuable productive resources but a crime against generations of people.

Direct Taxation in the U.S. is especially insidious because it pits one citizen against another through a progressive income tax. The Pure Investor could be a corporate CEO, a Wall Street trader, a pipe fitter, or a cop. He can also be among the richest of Americans or a recent immigrant with a small precious portfolio. All too often these people quarrel amongst themselves over pennies while Uncle Sam takes their dollars. All too often the rich view the poor as paying too little and taking too much from society. The poor view the wealth of the rich as ill gotten and undeserved. Not only is it divisive but as John Stuart Mill, the nineteenth century economist, stated "To tax the larger incomes at a higher percentage than the smaller, is to lay a tax on industry and economy; to impose a penalty on people for having worked harder and saved more than their neighbors."

While the rich and poor squabble among themselves, they fail to consider how much and how many times Uncle Sam takes a bite of the

same dollar. Every week that the Pure Investor brings home his paycheck, Federal income taxes, Social Security taxes, state income taxes, and local income taxes have reduced each dollar he toiled for. This is the first time this dollar is taxed. The Pure Investor takes a portion of that left over dollar and buys a share of stock. He is now a part owner of a corporation. When his corporation makes a profit, it gets taxed. This is the second time the dollar is taxed. The managers of the firm decide to pay a dividend to the shareholders. A dividend is a portion of the corporation's annual income it decided to pay out to the shareholders. The Pure Investor receives the dividend check in the mail. But at the end of the year, the amount of the dividend goes onto his Form 1040 along with his salary. This is the third time the dollar is taxed. Lastly, a few years go by and the Pure Investor has decided to sell his stock. He has a nice gain and wants to cash out to buy a home, pay his kid's tuition, or he wants to invest somewhere else. However, he must remember that because he made money on the original dollar he earned and put at risk, he will have to pay a capital gains tax. The capital gain is the difference in what his investment cost and the higher price he will eventually sell it for. The first dollar that the Pure Investor sweated for and brought home in his paycheck has now been directly taxed four different times. The Pure Investor notes that the government taxes all of the capital gains an investor incurs. However, when an investor incurs capital losses, he can only deduct from his income taxes $3,000 per year. The government is more than happy to participate in an investor's gains, but the investor is on his own when losses occur.

This does not consider what the government did with those taxes. It paid for the army, a police force, and the courts, but it also paid for milk, cheese and sugar subsidies that caused the Pure Investor's grocery bill to be higher. It paid for government regulators to require automakers to build his car smaller to use less gas, but also to add energy guzzling equipment to make it safer. Also, to deal with these direct taxes, the Pure Investor has to pay a CPA. The CPA has to calculate the proper tax payment and complete the required forms and paperwork. He then has to pay an estate lawyer to make sure he avoids taxes at death so that his children can keep a portion of the labor of his life. The fees these advisors charge are a choice imposed on him if he is to comply

fully and completely with the laws and regulations of the government. By the Pure Investor's definition these fees are yet another tax.

After these direct taxes have decimated the Pure Investor's income and returns, he can hear the final refrain of George Harrison's classic from the Beatle years, "I'm the Taxman, and you're working for no one but me." However, indirect taxes have yet to be considered.

Tax Two – Trade Restrictions

When a government places restrictions on the goods and services that the Pure Investor can buy thus raising prices it has again leveled a tax confiscating his profits for its own use. The Pure Investor's money belongs to no country. He lets his dollars flow to the highest returning environment. He is not a turncoat or a traitor. He simply knows that by putting his money where it will do him the most good it will do his country the most good. Although any benefits to his country are, while fortunate, only incidental.

During the 1980s, Lee Iacocca made a reputation and fortune for himself by bashing the Japanese and their auto industry. His two best-selling books had the tone of World War II propaganda films. Bumper stickers were stuck to rusting out American cars that read "Unemployment: Made In Japan." In the 1990s, Ross Perot jumped onto this bandwagon when he spoke out against the North American Free Trade Agreement (NAFTA). He said American workers would hear a "giant sucking sound" as jobs went south of the border. This theory of growth through trade restrictions was that if the U.S. built everything itself, it would be at full employment. Americans would be put to work manufacturing everything from sneakers to underwear to airplanes and supercomputers. Those opposed to NAFTA reasoned that if a wall was built along the Rio Grande and across the northern frontier with Canada, and all shipping ports were closed, and Americans were not allowed to buy from anyone but an American, the money and goods would accumulate to a fully employed U.S.A.

The Pure Investor prefers the freedom embracing and proven approach taken by Adam Smith, the 18th century Scottish father of modern economics. He did not see any folly in trade deficits. Smith

stated “What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom.” A trade deficit occurs to Country A when it buys more products from Country B than it sells to Country B. What Smith was trying to illustrate to his contemporaries and to the generations that followed was that every individual person is in a trade deficit. The Pure Investor is personally in a trade deficit to the grocery store, the auto shop, and Wal-Mart. He buys from them all the time, but they never buy any of his products or employ him in any way. The Pure Investor’s personal trade deficit is total. Using the same logic as Iacocca and Perot, the Pure Investor’s family should raise its own crops and livestock instead of making a weekly visit to the grocery store. It should also construct its own house out of wood that it raised and felled and milled itself and the home’s stone should be from the family’s own quarry. The Pure Investor’s family should generate their own electricity to power their lights. The Pure Investor should not buy anything from anyone to keep his own personal trade deficit low. By following this reasoning of Iacocca and Perot, the Pure Investor will keep all his money and be on the path to wealth.

Like Adam Smith, the Pure Investor has never understood why is it bad that a country has a trade deficit. A trade deficit means a country is getting more goods and services than it is shipping out to other countries. He asks, isn’t it better to have more goods and services and not less? The idea of a trade deficit being a bad thing is an erroneous belief.

The Pure Investor doesn’t worry that other countries are not buying American goods. If they wish to continue to trade with the U.S., they will be forced to open up their system. Monetary exchange is the pry bar that does it. When Toyota builds cars in Japan and sells them in the U.S., the Pure Investor knows that they are paid with U.S. dollars. The Pure Investor knows that the Japanese company must convert the dollars they were paid into Japanese yen to get them back to Japan. But, like any commodity, as they sell dollars and buy yen, the price of the yen will rise and, conversely, the price of the dollar will fall. If the yen continues to rise, it will take more dollars to buy a yen and Japanese products will become progressively more expensive to Americans. The American goods will become cheaper relative to Japanese goods until

no one is willing to buy anything made in Japan over something made in the U.S.

Taken a little bit further, the Pure Investor contemplates what else can Japanese manufacturers do with the U.S. dollars they earned from selling to Americans other than converting them to yen and taking them back to Japan. First, they can buy U.S. goods. While this hasn't happened to the extent that American business and government would like, the Japanese people are hurt more than U.S. citizens are. Their government has imposed on them a limited number of goods that they can purchase. Japanese freedom has been limited. The second thing the Japanese can do with their dollar is to invest in U.S. securities. If they do this, they obviously value U.S. businesses and believe they have a good future and will offer a good return. When this happens, U.S. companies use the Japanese money to expand their own businesses that increase U.S. employment and stock prices. The third thing that the Japanese can do with their U.S. dollars is to build factories in the U.S. to build their goods. They have already done this to a large extent. This has increased U.S. employment and tax revenue. Toyota has a factory in Georgetown, Kentucky; Mercedes Benz opened a plant in Tuscaloosa, Alabama; Nissan's facility is in Smyrna, Tennessee; and BMW manufacturers the ultimate driving machine in Spartanburg County, South Carolina. Across the United States, communities once solely dependent on agriculture have diversified their economic bases with foreign industry. The final option the Japanese have is to trade their dollars for the currency of another country with someone who wants U.S. dollars. The effect of this is the same as listed above; the U.S. benefits.

A huge uproar occurred in New York City when a group of Japanese investors bought the landmark Rockefeller Center. Similar to when Japanese investors buy U.S. securities, the Pure Investor knows that it meant they were the ones to pay the most for the property and that fellow Americans were free to profit by the sale. They bought it because they thought it was a good investment. As it turned out, the Japanese investors lost a fortune and a smarter U.S. company bought it several years later at a much lower price. This is known as the greater fool

theory. There is always a greater fool to buy something than the last one. Even Japan produces fools.

Of course, the arguments for trade restrictions are compelling when taken at face value but not when taken to their logical conclusion. One common complaint the Pure Investor hears is that once New England was the global leader in textile production. Now, the mills are shut down and almost all clothing is manufactured in Asian countries. First, the Pure Investor knows that Americans don't want their kids working in a textile mill. It is hard, brutal work. Second, if parents do want them working in the mill, they must either be prepared to pay their children the low wages that foreign citizens are paid or they should be ready to pay substantially increased prices for their three pack of BVDs. The Pure Investor knows that it is more productive for an economy to be designing the BVD's, making the material stronger, and designing better machines to weave the cloth than to be actually stitching the underwear. The U.S. is an educated, technologically driven society. More and more its citizens work with their minds instead of their backs. This is much more profitable.

On March 5, 2002, the White House announced temporary safeguards for the steel industry in the form of the Steel Revitalization Act of 2001. "Temporary safeguards" is a euphemism a self-proclaimed free trade president uses to increase tariffs on foreign goods and, wishfully, gets the favored industries political support. Advocates hoped that the safeguards would allow the steel industry to retool and become more competitive. This is similar to letting out a man's pants to encourage him to lose weight. It doesn't work because the process is backwards. It is welfare for corporations and has the same debilitating effect that welfare has on people. In response to the increased tariffs, the Consuming Industries Trade Action Coalition, a free trade lobbying group, conducted a study that found that even low tariffs on steel would save 4,375 jobs in the steel industry. But the cost of those jobs created by the tariff would be 36,164 other jobs throughout the rest of the country as other industries had to lay off workers to afford the higher steel prices. Each steel job saved would cost $439,485 to the U.S. consumer. The Pure Investor would rather pay a steelworker a fraction of the $439,485 to

stay home and watch TV and let the rest of the capital go to more productive uses.

In Holland, Michigan, the factory that produced the all-American candy *Life Savers* closed its doors and moved north to Montreal. A simple move north of the border allowed the candy company to produce the treat for less than 60% of the cost of manufacturing it in the U.S. This is because 90% of each single LifeSaver is sugar. The U.S. government spends millions of dollars to pay farmers not to raise sugar to keep prices artificially high. It then increases the cost of sugar even more to the U.S. consumers by imposing a tariff on foreign produced sugar. The Pure Investor knows that tariffs are a long-term political remedy to a short-term economic pain. When he hears pleas that removing tariffs and encouraging competition is harsh and unfair, he asks where are the subsidies for candle makers put out of work by the light bulb, blacksmiths displaced by the automobile, and slide rule manufacturers thrown into the street because of the hand-held calculator.

Tax Three – Immigration Control

The Pure Investor knows the immigrant is the high-octane fuel of the U.S. economic engine. As James P. Smith, the chair of a National Research Council report entitled *The New Americans: Economic, Demographic, and Fiscal Effects of Immigration*, stated "Immigrants may be adding as much as $10 billion to the economy each year." On average, the 800,000 legal and 200,000 to 300,000 illegal immigrants are individuals who have taken the initiative to cross oceans and deserts. They have thrown themselves into a foreign speaking environment and have decided to raise their children in a culture that is not their own. They have done so because they want to be successful and make money. For this reason, the phrase "illegal worker" is anathema to the Pure Investor's ears. The United States is one of the few countries where an immigrant can be rewarded for their risk-taking. Whether it's an Indian who works for a software start-up, a Chinese family who opens a laundry, or a Caribbean that drives a cab late into the night, they are the types of

people who take chances. Arnold Schwarzenegger describes the desires of all would-be immigrants perfectly when he said, "I came from Austria, a socialistic country where government controlled the economy. A place where you can hear 18-year-old kids talking about their pensions. I wanted more. I wanted to be the best. I had to come to America. I had no money in my pocket, but here I had the freedom to get it. I have been able to parlay my muscles into a big movie career."

If Herbert Hoover's Rugged Individualist is the archetype of an American, then a Laotian running his own hotdog stand has more of the American spirit than a 10th generation Connecticut Yankee. Few individuals put themselves through the trauma of coming to a new country for a welfare check. Although they may never have heard his name, each agrees with Henry David Thoreau when he said, "I know of no more encouraging fact than the unquestionable ability of man to elevate his life by a conscious endeavor."

The Pure Investor doesn't become sentimental over pictures of the hungry-eyed immigrants at Ellis Island or the sun parched rafters landing on a Florida shore. While he recognizes their bravery and zeal, he knows that life in a competitive free market is full of work and worry and he has sympathy for them. Unpleasant as it is, workers and their labor are a factor of production to be minimized and eventually eliminated when a more efficient alternative is found. To the Pure Investor, they are indistinguishable from the cost of steel, plastics, and computer chips. He doesn't care where the labor comes from. He wants the companies he has invested in to have access to the cheapest, best quality labor possible. As the National Research Council report found, "Immigrant labor allows many goods and services to be produced more cheaply, and provides the work force for some businesses that otherwise could not exist." It further stated that "businesses that employ many immigrants – such as restaurants and domestic household services – would not exist on the same scale without immigrant workers." When a politician advocates a plan to control immigration, he is reducing the supply of competition for possible employees. With fewer competitors, the price of labor rises, the pool of talent declines, and companies become less profitable. The Pure Investor's returns are reduced.

Tax Four – Regulation

The Pure Investor believes the role of government is to do what its citizens can't do for themselves. Government should establish a justice system, protect the country from foreign attack, and maintain a police force. Regulations are the reverse. A regulation is a requirement imposed by the government on the private sector to do something that the government doesn't want to do itself. Each of these requirements is another hidden tax that once again raises the Pure Investor's costs and lowers his return. The only French the Pure Investor knows is laissez-faire, a phrase from economics that has come to mean, "let people do as they choose without government interference." The more regulations that are imposed, the less likely the Pure Investor will risk his capital.

A recent report from the Regulatory Studies Program at the Mercatus Center at George Mason University estimated that the total cost of workplace regulation is at least $91 billion every year. Estimates of the total cost of all regulations are almost $808 billion annually. Faceless CEOs and rich stockholders do not pay this bill. The Pure Investor pays it by receiving less return for the risk that he has taken with his capital.

An obvious source of regulation is in the design of cars. In an effort to protect consumers again, Congress and the government, neither of which has ever built a car, has mandated several things through the National Highway Traffic Safety Administration. Cars must now have airbags, seat belts, cushioned dashboards, collapsible steering wheels, and reinforced firewalls. A car must be able to withstand collisions at certain speeds from the front end, rear end and side. Both head-on and off-side. After adding all this weight, Congress, through the Corporate Average Fuel Economy standards, then demands through regulations that the car be lighter and more fuel efficient to improve the miles per gallon of each car to protect the air the consumer breathes. If the automakers try to work together to minimize the costs of these regulations and learn from each other, the Anti-Trust division of the Justice Department cries "collusion" and drags them away from the factories and into the courts. The net effect is that the prices of cars have increased substantially. Lawyers are just as important as engineers to automakers.

The mother of three who the Politician claims to be protecting is not buying a newer, safer, cleaner, more expensive car, but is holding onto her older gas-guzzler with worn out brakes, balding tires, and frayed seat belts.

The Pure Investor doesn't want to drive an unsafe or polluting car. However, he resents the government imposing its will onto the public. If consumers wanted certain safety and environmental features, they would demand it through the marketplace and pay a higher price for them. Manufacturers would race each other to meet those demands. Only in this way do consumers have the freedom to choose and know the true cost. Under the current system, they must simply pay.

Regulations and their unintended consequences such as these spread throughout a society like kudzu strangling the productivity and vibrancy out of the economy. Regulations cause scarce money to be spent on more accountants and lawyers that don't add to the economy's value but only ensure compliance with government mandates. Firms are required to pay engineers not to build a better mousetrap demanded by consumers but to design the mousetrap to meet the regulatory demands of the Politician.

In addition, a number of these unfunded mandates are imposed to protect the worker. There are regulations concerning worker safety, racial and sexual discrimination, worker pay, retirement plans, and health benefits. There are even regulations on where to post the notice of the regulations for the workers. Each regulation is a link in the chain that businesses must drag with them like Marley's ghost. In a lean, competitive world economy, a vibrant corporation must be as unfettered as possible. If not and they become too unproductive because of this extra regulatory weight they must carry, the Pure Investor can easily direct his capital elsewhere. Further, over-regulated companies can automate, out-source, and go overseas which will lay off the same workers that the regulators claimed to be protecting. Then other taxes must be raised and regulations established to help and protect these unemployed people.

The Pure Investor realizes that there are benefits to regulations. But he demands that the benefits outweigh the costs. John Stuart Mill stated, "Every departure from (laissez-faire), unless required by some

great good, is a certain evil." Regulations are definitely evil in the eye of the Pure Investor.

Tax Five – Inflation

"Inflation is an insidious tax," Richard Nixon said. The Pure Investor agrees.

As Americans get further from the hyperinflation of the 1970's and early 1980's, investors forget the slow erosion of their assets that this "insidious tax" causes. The Pure Investor will never forget.

Inflation is best illustrated by a simple example.

There is a small, simple country that only produces apples. Currently, it is capable of producing only four apples. There are also only four dollars in this country. Thus we know that each apple costs a dollar. If our little government decided to print another dollar, each apple would cost $1.25 ($5/4 apples). Or put another way, each dollar that the citizen owned is now worth only 80% of its original value. Without the legislature passing a bill or taking a vote, the citizens of this small country just paid a 20% tax. This is what Nixon rightly said was so insidious.

Why don't the citizens just decide to not allow the government to print anymore dollars? The answer is deflation. Let's say that an economy grows and can now produce five apples instead of just four. Then the apples will cost $.80 ($4/5 apples). If this continued, the reverse of inflation – deflation – would set in. A man who borrowed $1 in January for 1 year at 10% interest would be expected to pay back $1.10, but the original dollar he borrowed is now only worth eighty cents. His effective interest rate would be 37.5%. Rates of this level are like sand in the economic engine. It violently halts all economic activity in a country.

To maintain stable prices, the amount of money circulating within an economy should grow at the same rate as the economy. So as businesses produce each apple, a proportionate amount of dollars should be printed. The Pure Investor knows the government is not good at matching the amount of dollars to the amount of goods produced. The government must determine a fixed, predictable increase in the money

supply that businesses and investors can depend on when doing their planning.

For centuries, countries used gold or silver to regulate the amount of money that was available in the economy. For every dollar that a government printed, there was a dollar's worth of gold held on reserve. As the country slowly grew each year, a similar amount of gold was discovered and mined. While this was not perfect, it was more reliable than what lay ahead.

On Sunday, August 15, 1971, the age of inflation began. It has been complicating the portfolio of the Pure Investor ever since. On that day President Nixon took the U.S. off the gold standard. It was one of the most momentous acts of his presidency but most Americans did not notice. The financial markets even seemed to shrug off the news. Several years later, even President Nixon didn't seem to comprehend the seismic shift in the economy that his decision caused. In his memoirs, he dedicated exactly three paragraphs out of its 1,122 pages to the closing of the gold window. Since that time, the U.S. has seen price instability that it had not experienced before, except during the 1860s when President Lincoln issued paper greenbacks to help finance the civil war. Since that time, Federal Reserve Chairmen, Treasury Secretaries, and Directors of the Office of Management and Budget have claimed that if we just follow their directions, unbounded prosperity is waiting for us. Without exception, these policies trip up the economy more than they help it run smoother.

The Pure Investor doesn't argue for a return to the gold standard, but only for a regular, predictable growth of the money supply. Nobel Laureate Milton Friedman argues that a computer that grows the money supply at 3% a year should replace the Federal Reserve Chairman. This approximately matches the long-term growth of the economy. While it may cause short periods of inflation and deflation, it is better than the unpredictable, politically influenced, herky-jerky movements of a money supply controlled by the Federal Reserve.

The Pure Investor knows that for his portfolio to stay ahead of inflation, he must take more risk to get a higher return. Although recently inflation doesn't seem to have been the *bête noire* that it once was, the Pure Investor knows that anyone over the age of 55 paid more for their

latest car than their first house. Their monthly grocery budget when first married doesn't cover a week and their annual salary from their first good job now looks like a joke to their twenty-something children. When asked if it will stop, the Pure Investor knows that it is unlikely. As Nixon said, inflation is an insidious tax. It is a way for the government to buy more stuff and repay less debt without passing a bill in Congress or holding an election. It has the added benefit of not costing them anything politically, because the American people do not understand it and the negative consequences occur years later after they have moved on to another office.

One of the horrors of modern government was the unnatural marriage it officiated between Tax One – Direct Taxes and Tax Five – Inflation. It's called bracket creep. It is another way for the government to raise taxes without the populous being aware. For example, consider the Pure Investor who is married and files jointly. He and his wife together make $45,000. Under the Economic Growth and Tax Relief Reconciliation Act of 2001, he is in the 15% tax bracket.

Tax Rate	Income Bracket
10%	0 – 12,000
15%	12,001 – 45, 200
27%	45,201 – 109,250
30%	109,251 – 166,500
35%	166,501 – 297,350
38.60%	Over 297,350

Table 1: Economic Growth and Tax Relief Reconciliation Act of 2001

For simplicity's sake exemptions and deductions are not considered. If the Pure Investor's income only increases by the amount of inflation (meaning his standard of living remains the same) and the tax brackets remain firm, within 5 years his income, assuming a 3% inflation rate, will be $52,167. However, the Pure Investor is now in the 27% tax

bracket. Although his standard of living has remained flat, his taxes have not. In fact, his taxes have gone up by almost $2,000 dollars. His representative government is slowly accreting away his way of life. For the Pure Investor in a higher tax bracket, creep is even more constricting. If he and his wife are making $160,000, under the same circumstances as above, his income after 5 years will be $185,483. Again, without any increase in his standard of living, his taxes jump by $7,500. Bracket creep punishes some of the most valuable and productive members of the economy.

A government that is aware of bracket creep has an incentive to induce inflation. The windfall to the Treasury is tremendous when the above examples are applied from household to household, corporation to corporation, town to town and state to state.

The Pure Investor has to ask himself whether at a certain level it is worth working. Jim Carey makes $20 million per film. He could easily decide to not work and he would not suffer in the slightest. However, the union cameraman will be out of a job, the makeup artist will have to look for work elsewhere for her highly specialized and technically skilled job and the minimum wage ticket taker in Des Moines may have to visit the welfare office because there is no incentive for Mr. Carey to use his strange talents. This line of thought is derisively called trickledown economics by some. Those same people should know that no one has ever asked for a job from a poor man. Why the Titans of Silicon Valley, the Billionaire Boys of Wall Street, and the other innovators and leaders of business persist after their initial fortune is made is incomprehensible to the Pure Investor. But he shudders at the thought of the Atlas's of the economy deciding to shrug this world off of their shoulders.

Before The Pure Investor Entered the Market

BEFORE THE PURE Investor entered the market place, he educated himself and was sure to understand the power of compound interest. Interest rates and rates of return paid and earned are used daily by the media and in the business transactions and day-to-day activities of the Pure Investor. Whether it's inflation data, mutual fund returns, car loan special incentives or office equipment leasing options, he needs to have a concrete number to put to these abstract concepts.

A quick rule of thumb that the Pure Investor uses to do this is the "Rule of 72." No matter what the number, as long as it has a percent sign behind it, the Rule of 72 puts into perspective the power of compound interest. It is a good guideline to the true profit or costs that it brings to his wallet.

Simply stated, an interest rate divided into 72 will yield how many years it takes for a figure to double. For example, 12 divided into 72 equals 6. Therefore, an investment earning 12% annually will double

every 6 years. Similarly, a 6% return will double the principal every 12 years (72/6%). An 18% credit card debt will double every 4 years (72/18%). Suppose the Pure Investor is offered two propositions. First, he can have either 1) $100,000 growing at 6% over the next 24 years or he can have 2) only $40,000 invested at the equity markets historical return of 12%. "Equities" and the "equity markets" are synonymous with "stocks" and the "stock markets". After quickly applying the Rule of 72, he chooses option number 2. Here's why: At 12%, money doubles every 6 years. At 6%, money doubles every 12 years. The following table illustrates why the Pure Investor made the choice he did.

Growth at 12%		Growth at 6%	
Year	Value	Year	Value
1	$40,000	1	$100,000
6	80,000	12	200,000
12	160,000	24	400,000
18	360,000		
24	640,000		

Table 2: The Rule of 72 Illustrated: $40,000 growing at 12% and $100,000 growing at 6%

Banks have used this principle for centuries. When a depositor puts money into his corner bank he is effectively loaning the bank money at a certain interest rate. The bank then invests the money elsewhere. It may loan the money at higher interest rates to families for mortgages or businesses for loans to finance inventory. Banks also invest in the stock market. The difference in the high returns they earn and the low returns they pay their depositors is the bank's revenue. It is such an integral part of the industry that is has a name: disintermediation.

The Pure Investor uses the Rule of 72 to help him stay focused during tough times in the market. He knows on average that the stock market will return about 12% over the long-term. At times, the return will rise and fall and drive the Pure Investor into fits of worry. He also knows on average that banks and bonds will pay about 6%. This return

will be upward, smooth and guaranteed. He also knows that the Five Taxes are constantly eating away at his earnings and his portfolio. If the Pure Investor decides to buy a bond that conventional investment advice says is safe and stable and earns a satisfying 6%, he is ignoring the eroding effects of The Five Taxes. He is ignoring the direct taxes he has to pay from this return. He is ignoring the increased cost of trade restrictions and immigration control and of the regulations on every item that he touches. Finally, he is ignoring the slow, erosive effects of the “insidious tax” of inflation. After the Five Taxes decimate his bond returns, the Pure Investor has hopefully broken even, but most likely fallen behind.

The Pure Investor Steps into the Market

FROM THE HIGHEST educated and most experienced investment advisor on Wall Street to the most urbane financial website posted from Silicon Valley, the advice given will dictate that depending on an investor's risk tolerance, time horizon, and investment experience, he should use a mix of equity investments and bond holdings. The younger the investor, these advisors state, the higher the percentage of stocks that he should hold. As an investor ages, this percentage decreases until some indeterminate time in the future where an investor should hold nothing but bonds. This is because bonds have a reputation as being safer.

The Pure Investor believes this is bunk. He follows the dictum: "Buy stocks to get rich. Buy bonds to stay rich." And the Pure Investor doesn't believe he is rich yet. He defines rich as being able to live the life of his dreams to the end of his long life and never possibly run out of money and leaving his heirs what he wants.

The Pure Investor views the investment arena as having two camps, ownership and loanership. The first group, ownership, owns equity investments; they own a piece of the company. They own stock in the

company. They get a piece of the profits and a piece of the growth. They also share in any losses. The other group, loanership, owns debt investments; they loan a company, government, or bank a certain amount of cash and the institution pays back a certain amount of interest. This group consists of Treasury bills, corporate bonds, and bank certificates of deposit. This interest is usually guaranteed unless the country, company or bank goes bankrupt.

Again, the Pure Investor views the options available to him as either loanership or ownership. Historically, an owner has always earned more than a loaner has. An owner has a vested interest in the growth of the firm's wealth. A loaner has a vested interest in receiving the interest he was promised. An owner's share of the profits is unlimited. A loaner's interest income is capped at the stated amount. The Pure Investor realizes that he would rather have owned Microsoft stock than Microsoft bonds. He knows that successful bank presidents are paid with options on their own stock and not with options on their own bank's CDs.

A simple search of Wiesenberger® InvestmentView databases for the twenty years ending December 31, 2001 has some interesting lessons. For that period, the best performing diversified stock fund was the Liberty Acorn Fund – Class Z. This was out of a total of 370 equity funds with a twenty-year history. It returned an 18.69% average annual return to its shareholders. The best performing diversified bond fund, Alliance Bond Fund – Class A, returned 11.68%. This was out of 156 bond funds with a twenty-year history.

For example, $10,000 invested in the Alliance Bond Fund – Class A over twenty years would have staggered to a respectable $91,054. Respectable until it's discovered that the $10,000 in the Liberty Acorn Fund – Class Z leapt to $308,058. That's a 238.3% difference.

Further, to do worse than the best returning bond fund for 20-years, you would have had to pick the 264th equity fund out of 370, the AmSouth Capital Growth Trust, and sat on it. It returned 11.67%. This is the reason the Pure Investor thinks of bonds as bondage. They keep him chained to his present condition, never moving him forward and probably holding him back.

The value of stocks can and do go down. This is commonly called risky. The only guarantee that a responsible investment advisor can

give the Pure Investor is that at the end of some year, the value of his stocks will be lower than it was at the beginning of the year. "But I don't want to lose my money," is a common concern the Pure Investor's poorer relations repeat. The Pure Investor asks, "What's riskier? A fast paced roller coaster ride to $308,058 or an uneventful merry-go-round ride to $91,054.

The stock market is an expensive place to learn who you are. A self-confident successful man may lay awake at night dwelling on possible losses and fretting about the world and the market disappearing with his money. Those who choose the safe and secure merry-go-round of loanership are deathly afraid of "losing money." It is an invalid fear. The only time an investor loses money in the stock market is when he sells when the prices are down. With proper planning and risk analysis, he will sell at regularly scheduled intervals not determined by the market, but by his own financial needs.

Traditional investment advisors will usually recommend a mixture of 60% stocks and 40% bonds for younger clients with the bond portion increasing as the client ages until the investor has a 100% bond portfolio at retirement. The Pure Investor uses a pure stock portfolio throughout the entire arc of his life. If it makes some investors more comfortable to have bonds in their portfolio then they should consider their Social Security payments a bond. In the Winter 2000 edition of the *Financial Services Review*, Steve P. Fraser, William W. Jennings, CFA, and David R. King published an article titled *Strategic Asset Allocation for Individual Investors: The Impact of the Present Value of Social Security Benefits.* The authors noted that the present value of Social Security benefits for a sixty-two year old retiring in the year 2000 making an annual income of $76,200 is $202,731. In other words, this individual can think of his Social Security benefits as a single bond worth $202,731. The authors further explained that when these benefits are included in a variety of individual investor's portfolios, the allocation of stocks based on traditional models is not 60% but between 90% and 100%. For most Americans, Social Security is their bond portfolio. All their other investments, with proper consideration of risk tolerance and investment objectives, should be invested into the stock market.

There are many ways to enter the stock market in this country.

One of the traditional methods is to buy individual companies directly through a broker. To construct his portfolio, he decides on twenty to thirty stocks to purchase that promise good returns with a minimum of correlation to one another. He then monitors the portfolio closely. The allocation is then constantly adjusted based on economic forecasts, business sector expectations, and the individual company's outlook. He replaces each stock when he decides the prospects are low and replaces it with one that is more promising. For most investors, this is an expensive, risky, and laborious route to take.

The expense not only has to deal with the sales commissions inherent in purchasing enough stocks to build a diverse portfolio, but also in following the stock. The twentieth century is littered with worthless stock certificates of once strong companies – Kodak, American Motors, International Harvester, Enron – to name few. Also, there are very good companies with decades long history that simply have not performed that well for shareholders during certain time periods. These include General Motors, Goodyear Tire, and Texaco. The average investor, even the Pure Investor, does not have the resources to dedicate to following a stock and the financial markets closely.

The main risk involved in buying individual stocks is emotion. The Pure Investor doesn't want to put himself in the position where he becomes emotionally attached to a stock that has done poorly or well. He doesn't want his pride keeping him from selling a loser or his haughtiness keeping him from selling a winner that has reached too high of a price. This is common amongst investors. A secondary risk is not building a well-diversified portfolio. An unbalanced portfolio will upset an investment plan more than any bear market.

To reduce risk and expenses and to acquire the services of a professional, powerful money manager, the Pure Investor chooses to use managed money – namely, mutual funds.

What Are Mutual Funds

A MUTUAL FUND is a company that invests in other companies. It issues shares of itself to its investors. With the money from the sale of these shares, it buys other companies that it thinks will increase in value. The person who decides what companies to invest in is the portfolio manager or money manager. The mutual fund company makes money by charging a fee, typically between 1%-3% of total assets under management. This annualized fee is taken out over each day from the account value of all its clients.

As the companies that the managers pick go up or down in value, the share price of the mutual fund goes up and down in value. The portfolio manager can pick any number of companies to invest in. So when the Pure Investor puts $1 into a mutual fund, that dollar is instantly divided and invested in as little as 10 to 30 companies up to several hundred, depending on the portfolio manager's investment style and stock picking choices.

When the manager decides that one company is no longer a good investment or thinks another company is a better investment, he either invests money raised from new clients or he has to sell shares of a

company. This sale will hopefully be for a gain. This gain, offset by any losses, is passed along to the clients. Also any dividends that the companies pay will also be passed on directly to the mutual fund shareholders.

The Advantages of Mutual Funds

THE PRIMARY ADVANTAGE that a mutual fund has for the Pure Investor over selecting and trading individual stocks himself is that the professional money manager has power. With the assets he has under his control he can get the attention of a CEO. The CEO's purpose is to make his company more profitable, thus increasing his firm's stock price and his stockholder's wealth. A CEO's role is manager, motivator, and entrepreneur, but mostly salesman. It is his job to make a company with a stock that sells at a higher and higher price in the marketplace. This is the sole reason the board of directors hired him.

The mutual fund manager has the power of millions of dollars to drive up a stock price or to pound it down. The Pure Investor knows that if the money manager has a question about a company's quarterly sales, inventory levels, or the corporation's strategic plans, he can pick up the phone and get the CEO to answer his questions. The mutual fund manager can tour the factory, speak with the clients and union representatives. He can send his firm's 150 analysts to pick apart the company. If he doesn't get these things, he doesn't buy. He sells and the

price drops. A corporate CEO will whore himself to anyone to avoid a 1/8-drop in price. He will pimp anyone to get a 1/8 increase.

Since the first mutual fund, the Philadelphia fund, was established in 1923, mutual funds have offered the powerful advantage of instant diversification. Whether the Pure Investor is a 22-year old investing $50 a month or a seasoned professional with a portfolio allocated across various market sectors and capitalizations, the next dollar that he puts into a mutual fund is instantly diversified across hundreds or possibly thousands of companies.

A professional money manager also has the power to perform comprehensive fundamental analysis that requires massive computing power to store and process the considerable information available and a diverse, competent staff to analyze, interpret and judge the results. Most business people, not to mention the average investor, don't have the power of knowledge to implement a multistage dividend discount model; to equate the value of a firm's inventory using FIFO accounting standards versus a firm inventory using LIFO accounting standards; to put a dollar value on intangible assets; or when to capitalize or expense a particular outlay. Most investors also don't have the ability to calculate a portfolio's correlation coefficient to measure the additional risk when an additional security is added to a portfolio.

No other investment instrument allows the Pure Investor this benefit at such a low cost with remarkable returns. Mutual funds win hands down when compared to having an individual broker build a portfolio with the ongoing costs that accompany it.

An additional advantage is the concept of a mutual fund family. A mutual fund company may offer many different types of funds. Each will usually be tailored to different sectors of the market. Each will have a different portfolio manager with its own investment objectives. When a company offers this, it has become a mutual fund family. Fidelity, Putnam, Janus, and T. Rowe Price are examples of mutual fund families. By dealing with one company and one customer service department, the investor can get access to a variety of funds and portfolio managers at a minimum of hassle.

The Disadvantages of Mutual Funds

THE FIRST DISADVANTAGE that the Pure Investor sees in mutual funds is a loss of control. He doesn't know at any one time what stocks the manager has purchased or why he bought them, when he purchased them, or when he plans on selling them. The best he can do is review outdated monthly or quarterly reports that give him a snap shot of the holdings that his manager has chosen. After careful introspection, however, the Pure Investor realizes that not having this control is a good thing. The manager stands as a barrier between the Pure Investor's emotions and his investment choices. He will not make decisions based on fear or hope or despair or euphoria. He will not commit common stock investor errors like falling in love with a company or avoiding a sector only because it is out of fashion. The job of managing the money falls to a manager who doesn't have irrational fears of losing his retirement nest egg or his kid's college money. The money manager can take the right actions for his client's portfolio based on strict fundamental analysis.

The second disadvantage is that the Pure Investor has no control over the amount of taxes distributed by the fund. For example, in 1999,

the Alliance Growth Fund – Class A returned 25.58% for the year. That means if the Pure Investor began the year with $100,000, he ended with $121,493 after commissions. But it distributed 14% of his initial investment in capital gains. The owner that started with $100,000 now had to add to his income tax return $14,079 he wasn't planning to pay taxes on. If the money wasn't invested in an IRA, 401k, or annuity, this is a tax bomb that no CPA can defuse.

The beginning mutual fund investor is always surprised when he receives a capital gains distribution and the accompanying tax bill when he never even sold his investment. The reason for this is the portfolio manager's trading done within the fund. When he sells a stock, it becomes a capital gain. The fund does not want to lower its returns by paying taxes, so it passes them on to its shareholders. The mutual fund thinks of dividends the same way. Again, dividends are a part of a corporation's income that it decided to pay out to its owners/investors. Capital gains and losses occur when an investment is bought and sold.

In 2000, the Alliance Growth Fund – Class A fund had distributions to its investors causing their taxes to increase while its returns were negative. Investors owed taxes on a fund that lost money! The Pure Investor knows that managing the taxes on an investment is just as important as managing the returns.

The lack of control of taxes is the primary disadvantage of mutual funds. However, this can be addressed using the Four Boxes.

The Four Boxes

THE PURE INVESTOR has entered the market, but he needs to decide how to divide his funds between the many legal and tax vehicles available to him. He has educated himself about the benefits and disadvantages of each and, while each may appear confusing to anyone without an accounting or law degree, they are actually easy to understand.

To simplify and categorize his investments, the Pure Investor divides his money into four convenient boxes. The driving force behind the Four Boxes is the tax code. Congress and the IRS divided investments based on the idea of pre- and post-59 ½ money. Some funds available to the Pure Investor are described as post-59 ½ or tax-qualified. Examples of tax-qualified investments are 401(k)s, IRAs, and variable annuities. These funds are considered tax-qualified because the investor will be charged a 10% penalty by the IRS if he withdraws the money before he reaches the age of 59 ½. After the investor becomes age 59 ½ the money is free of any IRS penalty – but not necessarily taxes. Boxes One, Two, and Three are pre-59 ½ money while Box Four is post-59 ½ money.

The amount of dollars the Pure Investor places in each box should increase as he goes from Box One to Box Four. This is a reflection of the advantages and costs of each box. The funds are piled higher and higher until the Pure Investor has a mound of financial success.

Box One – Ten-Minute Money

The first box that the Pure Investor fills up is his ten-minute money. These are the funds which he can gain access to with relative ease. This is his emergency fund where he can use an ATM to withdraw funds for a blown engine when he's out of town, a new furnace in the middle of winter, or bail money on a Saturday night. The funds are in a money market, a savings account, or a checking account. Again, the only advantage of this box to the Pure Investor is its liquidity. It has minimal returns and what returns it does give to the investor are fully taxable.

Some investors choose not to have a Box One at all. An open home equity line or a credit card with no balance can replace it. The Pure Investor examines himself and his motives before using a line of credit in place of the first box. He asks if he and his family have the discipline to not put a balance on the credit line. It may be a good investment move to not place funds in a low interest bearing account, but not if an investor's personality type increases his debt.

Money Market	*Mutual Funds/Variable Accounts*		
Box One	Box Two	Box Three	Box Four
10-Minute			
Advantage ▪ Liquidity Disadvantage ▪ Low Returns ▪ Taxable			

Illustration 1: Box One

Box Two – Taxable

The Pure Investor fills this box with straight mutual funds. The Pure Investor uses Box Two to save for a new home, an addition to his existing home, a new car or college savings. It is used for any long-term, non-retirement goal.

The first advantage of Box Two is common to the remaining boxes as well. That is, a well-diversified portfolio of well-managed mutual funds will offer good, and possibly great, returns. The second advantage is that Box Two funds are easy to get at. Although it does take longer than the ten minutes as with Box One, a fund company can usually take an order over the phone and have a check to the Pure Investor within seven to ten days. With Box Two, the Pure Investor gets to participate in good returns and have easy access to the funds.

However, the Pure Investor must deal with the capital gains and dividends generated by the fund. Capital gains result when a particular investment increases in value and the investor or fund company sells it for a profit. For example, if an investor buys one share of ABC Company at $10 and then sells that share two years later for $15, he has a $5 capital gain. Dividends occur when a company decides to pay out some of its income to its stockholders rather than reinvest it in their business. Usually near the end of the calendar year, fund companies will, as required by law, pass through their capital gains and dividends. Since the dividends and capital gains are passed through directly from the companies to the clients, the fund company doesn't pay any income taxes on it. The shareholder does. The amount of capital gains and dividends are determined by the fund's investment style, the manager's trading activity, as well as the performance of the market. These taxes are totally out of the Pure Investor's control. When the Pure Investor does sell the mutual fund itself, he will have to pay taxes on any gains he has on the share price of the mutual fund. This could lop off up to another 20% of the increased value of his investments.

The Pure Investor knows that he needs a certain amount of funds in Box Two for the liquidity it offers. Taxes, however, are an abomination

to him. He will do all he legally can to avoid them. His tools to accomplish this are Boxes Three and Four.

Money Market	*Mutual Funds/Variable Accounts*		
Box One	Box Two	Box Three	Box Four
10-Minute	Taxable		
Advantage ▪ Liquidity Disadvantage ▪ Low Returns ▪ Taxable	Advantage ▪ Market Returns ▪ Liquidity (7 – 10 Days) Disadvantage ▪ Taxable		

Illustration 2: Box Two

Box Three – Tax Preferred

This box is designed to give the Pure Investor the growth of mutual funds; the tax deferral of qualified retirement accounts with the added benefit of tax preferred withdrawals. While the money in Box Three does not have to abide by the IRS's 59 ½ rules, it still has many restrictions and must be monitored vigilantly. Consultation with a professional is required.

The content of this box is variable life Insurance. Many investors turn a deaf ear to life insurance of any kind mainly because they don't understand it. This is because of past unscrupulous, aggressive sales practices and poor marketing by insurance companies. However, the Pure Investor knows that the right kind of life insurance has an appropriate place in his portfolio.

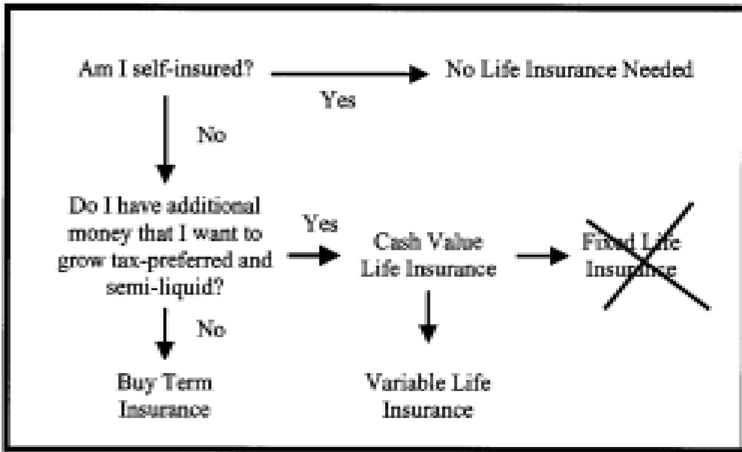


Illustration 3:
The Life Insurance Path

There is really only one type of pure life insurance. That is term life insurance which for a certain premium, an individual's life is insured for a certain amount of dollars for a certain amount of time. Upon the insured person's death, the beneficiaries receive the death benefit tax-free. With term insurance, the premium charged is equal to the true cost to insure a person's life.

For a variety of reasons, companies introduced cash value life insurance. This is simply term life insurance with an added on savings or investment component. These policies are best explained by an illustration. Cash value insurance is best thought of as a bucket. On the bottom of the bucket is a faucet. Premium dollars, which are larger than the actual cost to insure the life of the investor, are poured into the bucket. As long as the dollars stay in the bucket, the cash value can grow tax deferred. Once a month, the insurance company turns on the faucet at the bottom of the bucket and lets enough dollars drip out to pay the cost of insurance and other expenses associated with the policy. Again, the premium dollars put into the bucket are larger than the cost of insurance. The difference is what remains in the cash value account.

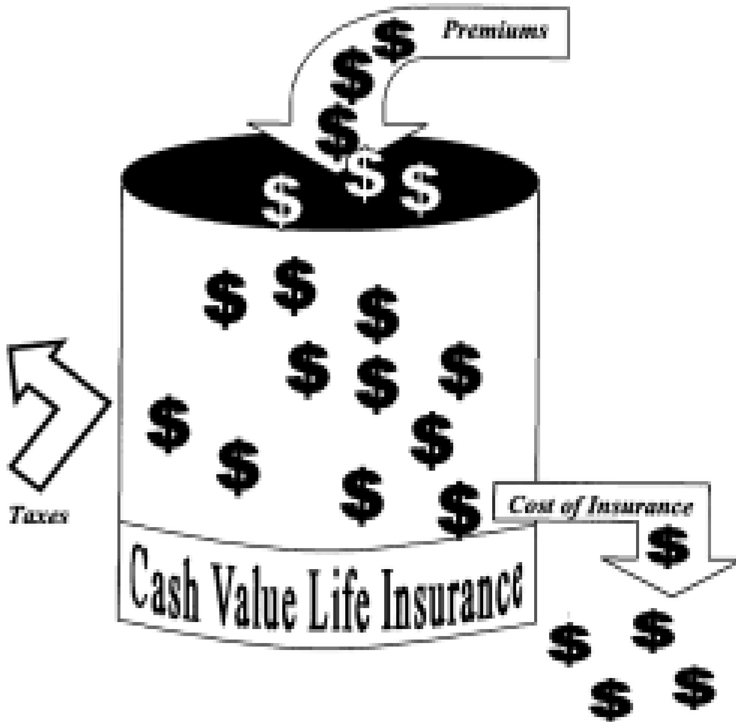


Illustration 4: The Life Insurance Bucket

There are basically two types of cash value life insurance from which to choose. One offers a fixed rate and the other a variable rate. The Pure Investor dismisses out of hand traditional whole life or universal life insurance contracts. These products offer a fixed rate of return on the contract's cash value component determined by the insurance company. This is similar to a bond or savings account that have no way of increasing the Pure Investor's assets at a rate that will overcome the Five Taxes.

Over time, many investors realized that fixed rate insurance was not only a bad deal but was incapable of fulfilling its promises. The solution devised to address this problem was the movement among many insurance salespeople to recommend "buy term and invest the difference." This strategy involves buying term insurance that is less expensive than most

cash value life insurance policies and investing the money saved on premiums into the equity markets. However, this meant that the investor only filled Box Two or Box Four. As shown earlier, there is a place for investments in Box Two but once that Box is filled, the tax disadvantages begin to weigh heavily on the Pure Investor's portfolio. Also, if Box Four is filled the money is not accessible until age 59 ½. A final problem is that once someone "bought term" they rarely followed through with "investing the difference."

When the insurance companies realized they were losing money to the "buy term and invest the difference" strategy, they battled back with variable life insurance. This is the Pure Investor's choice. He chooses to use a variable life policy because the cash value builds up into mutual fund-like sub-accounts with market based returns and risks instead of a guaranteed bond-like fixed payment determined by the insurance company.

The variable life insurance policy has many benefits. The first is, of course, the death benefit paid to the Pure Investors family after his death that, as with all insurance, is tax-free. The second is the higher possible returns with the market based cash value. The third is that those higher market returns in the growth of the cash value are tax-deferred. Just like the Pure Investor's 401(k), IRA, or annuity, no matter how large the cash value gets, as long as it remains in the bucket, the IRS will never touch it. However, the overriding benefit is that unlike his 401(k) or IRA, he will have access to the cash value before he is age 59 ½. This benefit of semi-liquidity is done through tax-preferred loans or withdrawals, which, if handled appropriately, may avoid a large portion of taxes.

Tax-preferred loans and withdrawals can be illustrated as follows. Let's say the Pure Investor is in need of a down payment for a car. He looks over his first two boxes and decides he doesn't want to utilize his 10-minute emergency money. Also, he doesn't want to sell any of his mutual funds in Box Two because this will trigger taxes on his mutual fund gains. If he has a large enough cash balance in the variable life policy, he can use those funds. First, he takes a withdrawal from the cash balance. This does not trigger any taxes. With all other investments, the IRS considers the first money taken out to be from gains and they immediately tax this amount. However, life insurance is the only vehicle where the IRS taxes gains on a first-in-first-out (FIFO)

basis. The IRS considers the first monies withdrawn from the variable insurance contract to be the original premiums or principle put into the policy – not gains. Therefore, there are no taxes levied against the Pure Investor.

If the Pure Investor takes enough withdrawals from the contract, he will reach a point where the amount withdrawn will equal the amount of premiums paid. The next dollar withdrawn will be part of the gains and will be fully taxed. However, the Pure Investor doesn't withdraw this dollar. He instead uses a loan option provided by the insurance company that uses his cash value life insurance as collateral. The company will loan the policyholder the requested amount and charge him a nominal interest rate. The company will then take the same amount from the variable insurance contract as collateral and pay it a slightly lower interest rate. This is a wash loan where the end effect is that the client is paying back the loan to himself. Loans are not taxable, so this allows the Pure Investor access to his money without giving the taxman his Shylockean pound of flesh.

There are several restrictions and considerations that must be weighted with a variable life insurance policy. The services of a financial professional are a requirement in handling this product correctly. While life insurance gets preferred treatment from the IRS, the Pure Investor must play by the IRS's stringent rules. If too much is put into the policy, it becomes a Modified Endowment Contract and is fully taxable. Also, because of the nature of life insurance, the Pure Investor must be in reasonably good health and able to prove it. Also, the better health he is in, the higher the return he will earn because the cost to insure his life would be lower.

If an individual is currently trapped in a fixed payment life insurance contract with a cash value that will soon be eroded by the annually increasing cost of insurance, there is a way out. The IRS has allowed for the transfer of cash values between life insurance contracts. It is not taxable as long as the transfer of cash value is sent directly between insurance contracts. This transfer is known as a Regulation 1035 exchange. The Pure Investor took this escape hatch out of a fixed insurance contract to jump-start his own Box Three.

Even with the restrictions imposed, it is a wonderful product. The Pure Investor asked himself, if this is such a wonderful product, why don't

more people use it and why hasn't the IRS begun to tax or limit its benefits? The answer to the first question is that the product is very complicated. It has many licensing requirements which limits the field of salesman. Further, it is difficult to explain to people that are already suspicious of life insurance salespeople. The answer to the second question is that the IRS hasn't gone after the variable life policies because Congress hasn't. Congress hasn't gone after them because life insurance lobbyists are the largest campaign contributors in Washington. The Center for Responsive Politics reports total financial industry lobbyist spending at $229,085,638 in the year 2000. Much of this is from the highly cohesive life insurance industry. This amount compares with $60,080,515 for the defense industry and $209,465,591 for the health care industry.

Variable life insurance has dynamic benefits that the Pure Investor can get nowhere else. It provides market-based returns, it is semi-liquid, and, when handled correctly, is tax-preferred by the IRS. Nevertheless, the investor must keep in mind that he must be insurable and must follow the maze of complicated rules applying to life insurance.

Money Market	*Mutual Funds/Variable Accounts*		
Box One	Box Two	Box Three	Box Four
10-Minute	Taxable	Tax Preferred	
Advantage ▪ Liquidity Disadvantage ▪ Low Returns ▪ Taxable	Advantage ▪ Market Returns ▪ Liquidity (7 – 10 Days) Disadvantage ▪ Taxable	Advantage ▪ Market Returns ▪ Tax-Preferred ▪ Semi-Liquid Disadvantage ▪ Must be Insurable ▪ Must Play by IRS Rules	

Illustration 5: Box Three

Box Four – Tax Deferred

Finally, in Box Four, the Pure Investor includes his tax-deferred investments. These include his IRAs, 401(k)s, and variable annuities. The benefit to Box Four assets is that they again provide great returns and the earnings are tax-deferred. Also, money may be invested "pre-tax" which means that the contributions are deducted from the Pure Investor's income before the taxman gets his cut thus lowering his overall tax bill. The main drawback is that these funds are illiquid for investors under the age of 59 ½. Any withdrawals before that age will be assessed a 10% penalty along with regular income taxes due.

The Pure Investor builds his Box Four in three steps. He begins by maximizing his company's 401(k), 403(b), or deferred compensation plan. Most plans offer one to two competent funds in each of the categories he wants to use. These dollars are taken out of his paycheck automatically. This benefits him in two ways. First, the money is taken out of his pay before the IRS looks at it. This lowers his tax bill at the end of the year. Second, it is easy for him. He doesn't have to remember to invest the money every two weeks. It imposes a discipline to invest on him. Another huge benefit of a 401(k) is that the Pure Investor's employer may match a portion of his contributions. This match is free money and there is no reason not to take advantage of this benefit.

The next step the Pure Investor takes in building his Box Four is to fund his and his spouse's IRAs. Mutual fund IRAs are the next best place for retirement money after a company 401(k) plan. All mutual fund companies offer IRAs so he has a variety of money managers and investment styles in which to place his money.

The final step the Pure Investor takes in funding his retirement is to use variable annuities. A variable annuity is an insurance product. It allows an investor to place money in it, have the money divided between several different mutual fund-like sub-accounts, and have it grow tax-deferred. A variable annuity has an optional feature called annuitization where the insurance company will, at a point in the future, pay a fixed amount of income for a specified time. This benefit is where the insurance portion of the annuity comes in.

No one can impinge the reputation of Individual Retirement Accounts or 401(k) plans. These vehicles have made many people wealthy. However, the variable annuity has received a bum rap from many popular financial magazines. This is mainly because they are products of insurance companies and insurance companies have made themselves good punching bags because of past transgressions. The main benefit of an annuity is that it allows funds to grow tax-deferred. This can be as little as $5,000 and there is no roof on how much can be put into an annuity. The tax-deferral is done at a cost of between 1.25% to 1.65% of the assets each year higher than what a comparable mutual fund would charge. For this, the insurance company will provide certain benefits in the contract. Each company offers a variety of annuities with a variety of different benefits. However, even if the Pure Investor chooses to use none of the benefits offered by an annuity he purchases, he would still consider it a great deal. He would rather pay a little bit to an insurance company than a lot to the taxman.

Money Market	*Mutual Funds/Variable Accounts*		
Box One	Box Two	Box Three	Box Four
10-Minute	Taxable	Tax Preferred	Tax Deferred
Advantage ▪ Liquidity Disadvantage ▪ Low Returns ▪ Taxable	Advantage ▪ Market Returns ▪ Liquidity (7 – 10 Days) Disadvantage ▪ Taxable	Advantage ▪ Market Returns ▪ Tax-Preferred ▪ Semi-Liquid Disadvantage ▪ Must be Insurable ▪ Must Play by IRS Rules	Advantage ▪ Market Returns ▪ Tax-Deferred ▪ Possibly Pre-Tax Disadvantage ▪ Not Liquid Before 59 ½

Illustration 6: The Four Boxes

The Pure Investor Builds a Mutual Fund Portfolio

As STATED PREVIOUSLY, traditional portfolio building involves acquiring a certain mix of stocks and bonds. This is called asset allocation. However, as demonstrated previously, the Pure Investor rejects bonds and instead he allocates his portfolio across several styles of equity mutual funds.

To begin building his portfolio, the Pure Investor uses a combination of small, middle, and large company mutual funds. This is called market-cap diversification. The size of a company is called its capitalization, or amount of stock in the company that investors own. For example, on June 25, 2002, Microsoft had 5,415,000,000 shares trading in the stock market. Its share price was $54.07. Thus, its capitalization was $292,789,050,000. Microsoft is considered a large capitalization stock or, in Wall Street shorthand, a "large cap." While there is no legal definition of what constitutes large, medium, and small companies, a good rule of thumb is that large companies have capitalization of over $10 billion. Mid-sized firms fall somewhere between $500 million to $10 billion,

and smaller companies are usually under $1 billion. However, these values change during bull and bear markets. Mutual fund rating company Morningstar considers the top 5% of the 5,000 largest companies large cap, the next 15% mid-cap, and the remaining to be small cap.

No matter how size is defined, different size companies don't move in tandem. Higher returns rotate through each of these size sectors on a cyclical basis. The amount of exposure to each of these levels determines what returns the Pure Investor earns. In addition, diversifying across the full range of companies lowers the mutual fund owner's overall risk. Therefore, the result of diversification across small, medium, and large capitalization stocks is more consistent returns at lower risk.

The Pure Investor also uses a mixture of value funds and growth funds in building his portfolio. This is called style diversification. The difference between value funds and growth funds is the type of company that each portfolio manager is looking to invest in. The value manager is looking for out-of-favor stocks whose assets and future income he calculates as being worth more than its current stock price. The value manager looks for the price to come up to his expectations. The growth manager is looking for "hot" stocks that have produced above average returns in the recent past and are expected to carry that momentum into the future. The growth manager rides a wave of positive sentiment about the company.

A common measurement of whether a stock is value or growth is its price ratios, also known as its multiples. For example, at any point in time the average Price to Earnings ratio (P/E) for every stock in the market may be 14. This is the average price of all shares divided by the last quarterly earnings per share annualized. When a stock's P/E ratio on an individual basis is lower than 14, it may be considered a value stock because the price is lower relative to its earnings compared to the market average. The converse is true for stocks with P/E's above the average. Wall Street analysts, by far, do not standardize these. P/E ratios can be calculated in different ways. Other analysts may feel that Price to Book Value Ratio (P/BV) is a better measurement. This is the price of the stock divided by the value of the company if all the assets where sold and the debts paid off. Still other analyst may feel that Price

to Free Cash Flows (P/FCF), a more complicated accounting concept, better represents the value or true cost of a company. These ratios are further complicated by the fact that earnings, book value, and free cash flows are calculated in different ways by different companies.

The Pure Investor often thinks of the difference in value funds and growth funds using a horse racing analogy. As detailed in Laura Hillenbrand's book *Seabiscuit: An American Legend,* Charles Howard bought the thoroughbred Seabiscuit for a "bargain-basement price" in 1938. The previous two years Seabiscuit "floundered at the lowest level of racing, misunderstood and mishandled, before his dormant talent was discovered." The horse went on to win race after race thus "establishing himself as the single biggest newsmaker of 1938 – receiving more coverage than FDR or Hitler." Charles Howard was a value investor.

By contrast, in 2002 Saudi Prince Ahmed bought 90% of thoroughbred racehorse War Emblem for $900,000. The horse went on to win the Kentucky Derby and Preakness Stakes. While not winning the Triple Crown, the mount had a bright outlook for winning future races and high stud fees. Prince Ahmed bought a winner and he paid a "winner" price.

Finally, a small portion of his portfolio is allocated to companies based outside of the U.S. As with large and small companies and value and growth firms, domestic companies do not move in tandem with foreign countries. This is called geopolitical diversification.

Luckily, the Pure Investor doesn't have to choose one style over the other. He can mix value and growth investing. Sometimes the overlooked, under-appreciated horse with spirit will outshine all expectation. Other times, it's a good decision to stick with a proven winner with good bloodlines. Either way, the Pure Investor wins. Just as small and large companies do not move in tandem, value and growth companies take turns as performance leaders.

To illustrate the benefit of using a variety of investment styles for diversification, the Callan organization each year publishes a table of investment returns since 1982. As seen on Table 3, returns of each market sector have a cyclical nature. Often the best performing sector

in one year falls from the top the next. Often, poorer performing sectors climb to the top. This illustration can prove two important points that the Pure Investor makes frequently which is the benefit of using an equity-only portfolio and of diversifying across equities.

In Table Four, $1,000 is invested into each of the eight market sectors including bonds every year for a total of $8,000. Table Five assumes an investment of $1,142.86 into the seven equity (no bonds) sectors for the same total of $8,000. The equity-only investment outperformed a more traditional asset allocation model by $32,589. While the equity-only investor experienced more volatility, he made almost four times his annual contribution of $8,000. The Pure Investor is able to handle the additional volatility because he has educated himself on the market's behavior and understands that while the market may take a step back every once in a while, it is more often moving forward.

The second lesson of the Pure Investor that the Callan table can teach is to diversify across different market sectors. As can be seen on Table 6, the $8,000 was invested into each sector. Four of the seven sectors did not outperform the well-diversified equity-only allocation return of $689,386. Therein is the problem. If an investor were chasing the most recent best performance, he would have first invested in bonds, but would have been quickly outperformed. Then for the three years from 1985 to 1987, foreign stocks provided the best returns. When he jumps into these stocks in 1988, they are laggards for several years. In 1993, the investor reviewed the recent past and couldn't see any consistent winners. What he doesn't expect is large cap growth to have a nearly six-year streak of being the best performing sector. When he finally plunged into this sector in the late 1990's, the bottom soon fell out of the market and large cap stocks lost double-digit figures for several years.

As stated previously, looking at the best performing sector a year later consistently shows a drop to the bottom the next year. The Pure Investor is not smart enough to know which market sector will do best during any given year. He spreads his assets across each equity sector, thus balancing his equity returns and lowering his risk.

Year	LB Agg	Russell 2000 Value	Russell 2000	S&P 500 BARRA Growth	S&P 500 Index	S&P 500 BARRA Value	Russell 2000 Growth	MSCI EAFE
1982	32.65%	28.52%	24.95%	22.03%	21.55%	21.04%	20.99%	-1.86%
1983	8.19%	38.63%	29.13%	16.24%	22.56%	28.89%	20.14%	23.69%
1984	15.15%	2.27%	-7.13%	2.33%	6.27%	10.52%	-15.84%	7.41%
1985	22.13%	31.01%	31.04%	33.31%	31.73%	29.68%	30.97%	56.14%
1986	15.30%	7.41%	5.69%	14.50%	18.67%	21.67%	3.59%	69.46%
1987	2.75%	-7.12%	-8.76%	6.50%	5.25%	3.68%	-10.48%	24.64%
1988	7.89%	29.47%	24.89%	11.95%	16.61%	21.67%	20.38%	28.26%
1989	14.53%	12.43%	16.25%	36.40%	31.69%	26.13%	20.16%	10.53%
1990	8.96%	-21.77%	-19.50%	0.20%	-3.11%	-6.85%	-17.42%	-23.45%
1991	16.00%	41.70%	46.05%	38.37%	30.47%	22.56%	51.18%	12.14%
1992	7.40%	29.15%	18.42%	5.06%	7.62%	10.52%	7.77%	-12.18%
1993	9.75%	23.86%	18.89%	1.68%	10.08%	18.61%	13.37%	32.57%
1994	-2.92%	-1.55%	-1.81%	3.14%	1.32%	-0.64%	-2.44%	7.78%
1995	18.46%	25.75%	28.44%	38.13%	37.58%	36.99%	31.04%	11.21%
1996	3.64%	21.37%	16.53%	23.97%	22.96%	22.00%	11.32%	6.05%
1997	9.64%	31.78%	22.36%	36.52%	33.36%	29.98%	12.93%	1.78%
1998	8.70%	-6.46%	-2.55%	42.16%	28.58%	14.69%	1.23%	20.00%
1999	-0.82%	-1.48%	21.26%	28.25%	21.04%	12.72%	43.09%	26.96%
2000	11.63%	22.83%	-3.02%	-22.07%	-9.10%	6.08%	-22.43%	-14.17%
2001	8.44%	14.03%	2.49%	-12.73%	-11.88%	-11.71%	-9.23%	-21.44%

Table 3: Annual returns of each market capitalization/style sector

Year	LB Agg	Russell 2000 Value	Russell 2000	S&P 500 BARRA Growth	S&P 500 Index	S&P 500 BARRA Value	Russell 2000 Growth	MSCI EAFE	Total
1982	1,327	1,285	1,250	1,220	1,216	1,210	1,210	981	11,681
1983	2,517	3,168	2,905	2,581	2,715	2,849	2,655	2,451	23,824
1984	4,050	4,263	3,626	3,664	3,948	4,254	3,076	3,706	32,572
1985	6,167	6,895	6,062	6,218	6,518	6,813	5,338	7,349	53,346
1986	8,264	8,479	7,464	8,265	8,922	9,506	6,566	14,148	73,600
1987	9,519	8,805	7,723	9,867	10,443	10,893	6,773	18,880	84,889
1988	11,349	12,694	10,894	12,165	13,344	14,470	9,357	25,498	111,759
1989	14,143	15,396	13,827	17,958	18,889	19,513	12,445	29,289	143,448
1990	16,500	12,827	11,935	18,995	19,271	19,107	11,103	23,186	134,914
1991	20,300	19,592	18,892	27,668	26,447	24,644	18,297	27,122	184,953
1992	22,876	26,595	23,556	30,118	29,538	28,341	20,797	24,697	208,511
1993	26,204	34,179	29,195	31,641	33,617	34,802	24,711	34,066	250,408
1994	26,409	34,634	29,649	33,666	35,074	35,573	25,084	37,794	259,877
1995	32,469	44,810	39,365	47,884	49,630	50,101	34,180	43,143	343,578
1996	34,688	55,599	47,037	60,602	62,255	62,343	39,162	46,814	410,496
1997	39,128	74,587	58,778	84,099	84,357	82,334	45,355	48,665	519,299
1998	43,619	70,704	58,254	120,976	109,752	95,575	46,925	59,598	607,402
1999	44,253	70,642	71,851	156,435	134,054	108,860	68,577	76,935	733,606
2000	50,516	87,998	70,651	122,689	122,764	116,539	53,971	66,892	694,020
2001	55,864	101,485	73,435	107,943	109,061	103,775	49,897	53,336	656,797

Table 4: $1,000 Invested into each market capitalization/style sector

Year	LB Agg	Russell 2000 Value	Russell 2000	S&P 500 BARRA Growth	S&P 500 Index	S&P 500 BARRA Value	Russell 2000 Growth	MSCI EAFE	Total
1982	0	1,516	1,469	1,428	1,395	1,389	1,383	1,383	11,945
1983	0	2,877	3,621	3,320	2,950	3,103	3,256	3,034	24,143
1984	0	4,628	4,872	4,144	4,188	4,512	4,862	3,515	32,706
1985	0	7,048	7,879	6,928	7,106	7,450	7,787	6,101	52,285
1986	0	9,445	9,691	8,531	9,445	10,197	10,864	7,504	67,662
1987	0	10,879	10,062	8,826	11,276	11,935	12,449	7,741	75,155
1988	0	12,970	14,507	12,450	13,903	15,250	16,537	10,694	98,300
1989	0	16,163	17,596	15,802	20,523	21,588	22,300	14,223	130,184
1990	0	18,857	14,659	13,641	21,709	22,024	21,837	12,689	127,406
1991	0	23,200	22,391	21,591	31,620	30,225	28,164	20,911	180,095
1992	0	26,144	30,394	26,922	34,421	33,758	32,390	23,768	209,790
1993	0	29,947	39,062	33,366	36,161	38,419	39,774	28,241	246,964
1994	0	30,182	39,582	33,884	38,476	40,084	40,655	28,667	253,524
1995	0	37,108	51,211	44,989	54,725	56,720	57,259	39,063	343,069
1996	0	39,643	63,542	53,757	69,259	71,149	71,250	44,757	415,353
1997	0	44,718	85,242	67,175	96,113	96,408	94,096	51,835	537,584
1998	0	49,850	80,804	66,576	138,259	125,431	109,229	53,629	625,777
1999	0	50,575	80,734	82,116	178,783	153,205	124,411	78,373	750,197
2000	0	57,733	100,570	80,745	140,216	140,302	133,188	61,681	716,434
2001	0	63,845	115,983	83,926	123,364	124,641	118,601	57,025	689,386

Table 5: $1,142 ($8,000/7) Invested into each market capitalization/style sector

Year	LB Agg	Russell 2000 Value	Russell 2000	S&P 500 BARRA Growth	S&P 500 Index	S&P 500 BARRA Value	Russell 2000 Growth	MSCI EAFE
1982	10,612	10,282	9,996	9,762	9,724	9,683	9,679	7,851
1983	20,136	25,344	23,238	20,647	21,723	22,792	21,240	19,606
1984	32,399	34,101	29,011	29,314	31,586	34,031	24,608	29,652
1985	49,339	55,156	48,499	49,744	52,147	54,506	42,707	58,790
1986	66,112	67,836	59,714	66,117	71,376	76,051	52,527	113,182
1987	76,150	70,436	61,782	78,934	83,543	87,144	54,184	151,041
1988	90,790	101,552	87,151	97,323	106,749	115,762	74,857	203,986
1989	113,144	123,169	110,613	143,661	151,113	156,101	99,561	234,308
1990	131,998	102,613	95,483	151,964	154,164	152,860	88,824	185,487
1991	162,398	156,739	151,138	221,342	211,576	197,150	146,379	216,976
1992	183,008	212,761	188,451	240,947	236,308	226,732	166,374	197,574
1993	209,631	273,434	233,560	253,129	268,934	278,415	197,688	272,530
1994	211,276	277,072	237,188	269,329	280,589	284,582	200,669	302,355
1995	259,754	358,478	314,920	383,074	397,041	400,809	273,440	345,146
1996	277,501	444,795	376,298	484,815	498,039	498,746	313,299	374,511
1997	313,023	596,693	470,227	672,790	674,853	658,669	362,842	389,320
1998	348,952	565,629	466,033	967,812	878,012	764,603	375,404	476,784
1999	354,025	565,140	574,812	1,251,478	1,072,429	870,878	548,613	615,482
2000	404,128	703,988	565,211	981,512	982,110	932,313	431,764	535,134
2001	446,912	811,879	587,484	863,547	872,485	830,203	399,174	426,686

Table 6: $8,000 Invested into each market capitalization/style sector

When the Pure Investor is younger, he uses more aggressive funds. Small company mutual funds historically produce higher returns and greater volatility, but he has time to ride out these ups and downs. He splits his money between value and growth funds. As he ages, he lets larger, more stable firms dominate his portfolio. He also starts to focus on mutual funds that hold companies that pay dividends. These funds are even more stable.

All the while, the Pure Investor is invested in "risky" stock funds without the traditionally recommended bond mutual funds to dampen risk, but he allocates and builds his portfolio with stock funds of different styles and sizes.

Think long-term

When building an equity mutual fund portfolio, the fear that most people have is of losing their money. However, the Pure Investor is concerned with outliving his money. More and more people are realizing this as medical science increases life expectancy each year. According to the National Center for Health Statistics, a newborn in 1950 was expected to live 68.2 years. By the year 2000, the figure had increased to 76.9 years. Consider this example. A pharmacist is retiring. The year is 1971. He is 60 years old and expects to live probably 10 to 15 more years. This is a reasonable assumption. He has a choice. Should he put his retirement nest egg of $100,000 into a bank, some government bonds, or some AAA-rated, high-quality corporate debt, all of which are considered by many to be safe investments with no worries? Or should he place his money in the stock market? He knows he can make more money there but the idea of losing his retirement nest egg terrifies him.

The pharmacist plans on putting his $100,000 into fixed income investments and withdrawing 6% per year ($6,000) and will increase that amount by 4% each year to keep up with the cost of living. Adjusting for his income for inflation was very prescient of him before the age of inflation dawned (see Table 7).

Year	Amount Invested	Withdrawals	Value
1970	$100,000	0	$100,000
1971	0	$6,000	$106,972
1972	0	$6,240	$110,112
1973	0	$6,490	$104,158
1974	0	$6,749	$95,464
1975	0	$7,019	$101,238
1976	0	$7,300	$108,991
1977	0	$7,592	$105,297
1978	0	$7,896	$100,257
1979	0	$8,211	$94,622
1980	0	$8,540	$87,778
1981	0	$8,881	$82,856
1982	0	$9,237	$97,644
1983	0	$9,606	$95,345
1984	0	$9,990	$95,138
1985	0	$10,390	$103,495
1986	0	$10,806	$106,859
1987	0	$11,238	$98,353
1988	0	$11,687	$93,993
1989	0	$12,155	$93,216
1990	0	$12,641	$86,837
1991	0	$13,147	$85,995
1992	0	$13,673	$77,636
1993	0	$14,220	$70,306
1994	0	$14,788	$54,336
1995	0	$15,380	$46,234
1996	0	$15,995	$31,541
1997	0	$16,635	$16,730
1998	0	$16,838	0
1999	0	0	0
2000	0	0	0
2001	0	0	0

Table 7:

Income from Bank Pooled Fixed Income Investment

He does all right through the turbulent 70's because of its high interest rates, but by the 80's the 6% of his investments that he takes as income just doesn't seem to keep up with the cost of living. He did not expect to live this long. He begins taking fewer trips and dining out less. In the 90's, he depends increasingly on Social Security and frugal living to make ends meet. Finally, in 1998 the life expectancy tables fail him. He has lived longer than he ever thought possible and has now run out of money. The average annual return during this time was 8.12%. This is not a bad return by many standards. However, he has still run out of money. He has no savings on which to live and is unable to leave anything to his children. The Pure Investor knows that this has happened repeatedly to those who were afraid of losing their money. To assuage his fear of losing money, the pharmacists completely missed the very real concern of running out of money.

The Pure Investor at that time and in those circumstances would have put all his net egg into the stock market. He would have ignored conventional wisdom to allocate a large portion to bonds. He is not rich which, according to his definition, means that there is no way that he will outlive his money. It is assumed he'll place his funds with the Pioneer Fund only (see Table 8). The Pioneer Fund is used for ease of illustration and not because the Pure Investor recommends it as a fund for all to use.

Year	Amount Invested	Withdrawals	Value
1970	$100,000	0	$96,537
1971	0	$6,000	$103,314
1972	0	$6,240	$112,544
1973	0	$6,490	$102,347
1974	0	$6,749	$77,123
1975	0	$7,019	$99,813
1976	0	$7,300	$128,628
1977	0	$7,592	$125,483
1978	0	$7,896	$132,698
1979	0	$8,211	$160,597
1980	0	$8,540	$199,971
1981	0	$8,881	$185,218
1982	0	$9,237	$199,177
1983	0	$9,606	$238,709
1984	0	$9,990	$226,234
1985	0	$10,390	$273,498
1986	0	$10,806	$293,925
1987	0	$11,238	$299,762
1988	0	$11,687	$342,454
1989	0	$12,155	$409,539
1990	0	$12,641	$354,145
1991	0	$13,147	$420,792
1992	0	$13,673	$463,492
1993	0	$14,220	$514,375
1994	0	$14,788	$496,662
1995	0	$15,380	$612,034
1996	0	$15,995	$715,054
1997	0	$16,635	$970,888
1998	0	$17,300	$1,233,342
1999	0	$17,992	$1,405,482
2000	0	$18,712	$1,388,625
2001	0	$19,460	$1,215,149

Table 8:
Income from Pioneer Fund Investment

This is a conservative growth and income fund. Its prospectus can be obtained at *www.pioneer.com*. Under the same scenario as above, he would have enjoyed the same income stream, however, in 9 of the years shown his account would have gone down in value. For example, by the end of 1974 the account value would have been less than what he had invested five years earlier. In 1990, the Pure Investor's Pioneer account value went down by $55,394. This is over half of what the Pure Investor originally put into the fund. It is also more than his salary was at the time of his retirement. Further, by the last year of the illustration, 2001, the value had been set back to levels it had achieved four years before. This represents a loss of $190,333 from its 1999 year-end high. The Pioneer fund yielded 12.47% during this time frame. He lost money in several year-end to year-end snapshots. But he did not run out of money. Anytime that he felt his standard of living was dropping he did not have to depend on Social Security and frugal living but could have given himself a raise. He could have purchased a vacation home or a new car. But if he kept to his original plan of 6% withdrawals, he would have $1,215,149 to live off of for the rest of his life or to leave to his family.

The Pure Investor did have some times when his accounts were down, but faith in the market and a long-term perspective kept his fear of losing money at bay and his concern of running out of money clear.

The most useful investment tool that the Pure Investor has in his portfolio is time. The 2.6-year average holding period of the typical mutual fund investor is by far not the long-term. The Pure Investor thinks investors should take on more of Chairman Mao's perspective of time. When, in the 1960s, the Chairman was asked about the consequences of the 1789 French Revolution on the modern Western world, he is said to have stated "It's too soon to tell." In a long-term perspective of several years, the markets are an accurate reflection on the value of individual firms and the economy as a whole. In the short-term, the markets are possessed by what British economist John Maynard Keynes called "animal spirits." Keynes further stated that short-term market prices are determined by "the outcome of the mass psychology of a large number of ignorant individuals [and] is liable to change violently as the result of a sudden fluctuation of opinion." One

of the Pure Investor's mantras is "In the short-term, the markets are unknowable, in the long-term they are inevitable."

The market is like a man walking up a hill playing with a yo-yo. The man's slow and steady process up the hill is how the market behaves in the long-term. He slows down, he speeds up, he stops to rest every once in a while, and he might even trip or fall back. The bouncing of his yo-yo is the short-term gyrations of the market. The Pure Investor knows he has time on his side and chooses to watch the man's slow trek up the hill, not his bouncing yo-yo.

A research report sponsored by Janus and compiled by FactSet Research Systems, Inc. details how being spooked by a wild bounce of the yo-yo can derail an investor. If an investor had invested $1,000 in the S&P 500 in 1981 by the end of 2000 he would have had $9,725. If an investor had become frightened or nervous about the market and had missed just the 10 best days of the market during that time, his return would have been decreased to $5,915. Had he missed the 20 best days he would have only had $4,176. Again this is over a 20-year period. Warren Buffet, the superstar investor known as the "Sage of Omaha", stated that "people's investments would be more intelligent if stocks were quoted once a year." The Pure Investor has learned these lessons intently and repeatedly. He knows that wealth comes from time in the market, not attempting to time the market. He does not jump when the markets soar or duck when the markets plummet. He maintains his constant even stride up the hill.

When to Sell A Mutual Fund

Buying a mutual fund is easy. "Money Magazine" declares on its cover the ten best funds to buy for the next year every other month. A more difficult decision is when to sell that mutual fund. If the Pure Investor has selected good money managers, then there is no need to sell because of short-term performance numbers. However, the Pure Investor has two primary tests he uses to determine if a mutual fund should be sold.

First, he will consider a change if there has been a change of money manager. The Pure Investor doesn't buy a mutual fund per se but hires

a money manager because a fund is only as good as the person running it. If he has bought a fund because of the talent and experience represented by the manager, then selling this fund when the manager leaves may be a good idea. However, if a star money manager does leave, don't expect the fund to announce the arrival of a new manager with a great deal of fanfare. The change will be buried in some innocuous looking junk mail. Peter Lynch, the superstar fund manager of Fidelity Magellan, left active management of mutual funds in 1990. Yet, he is still doing commercials for the fund family giant. Many passive investors think he is still managing money for them. Fidelity is also using the return numbers from his tenure at the fund in its performance history even though he hasn't contributed to its returns for over a decade. This is a reason to use a professional investment advisor who is intimately knowledgeable of mutual funds and the industry.

One way to solve this dilemma is to use funds managed by a team instead of one single manager. The Pure Investor believes it's easier for the fund to maintain its focus when four or five people jointly make the decisions and keep each other in check. With a team managing a mutual fund, a single person's hubris cannot force the fund to jump its tracks.

A second reason why the Pure Investor may consider selling a fund is if there has been a change in the objective of the mutual fund. If a mutual fund says that it is a small company value fund and an analysis of its holdings reveals large, hot, trendy growth companies, the fund has lost its focus and it not what the Pure Investor bought. Jeff Vinik became captain of the Fidelity Magellan flagship a few years after Peter Lynch. The Magellan fund is described as a large-cap domestic equity fund. Simply put, it told the public that it only invests in the stock of large companies based and doing much of their business in the United States. However, by 1996 the premier stock fund had reached a total of 30% of its assets in cash and bonds just before an upswing in the market. Returns were terrible. There is nothing morally wrong with holding bonds except when the fund is advertised as a large-cap domestic equity fund.

A more discrete but no less pernicious form of an objective change to the Pure Investor is style drift. This occurs when a small-cap value fund manager buys within the fund's declared objectives but the stocks

that it is holding are so good that they become larger and more growth oriented. The returns are great and the performance of the fund is well received. This is common in a raging bull market. However, the fund is no longer holding stocks within its stated objectives. If the Pure Investor has built a portfolio of mutual funds designed to accomplish his objectives, a fund changing its objective or a small-cap value portion of their portfolio drifting into a large-cap value fund has seriously destabilized and unbalanced the Pure Investor's portfolio.

Once chosen, a mutual fund should rarely be replaced with another unless the owner's circumstances or the fund management has changed. A fund should not be replaced because it has lagged behind another market sector. Each will have its day in the sun. A review of the Callan table reminds the Pure Investor of the words written in Ecclesiastes 3 and sung by Roger McGuinn of *The Byrds* that "To every thing there is a season, and a time to every purpose."

Learning from the Pure Investor's Mistakes

The Pure Investor is not immune from mistakes. However, he understands the only true mistake is not learning from each error. The following is a list of mistakes in no particular order that the Pure Investor has made.

This book began with a list of influences that the Pure Investor said to throw off in order to become a better investor. The media, the church, politicians, and CEOs tell the people of the world what views to hold. A new breed of mutual funds has been designed to feed upon those investors who are converted by these false prophets. They are called socially conscious mutual funds. They only invest in companies that do not do business in certain areas or in a certain manner that people find offensive. However, once all the companies have been discarded that do not meet the fund's moral standards, the universe of available companies is very small. Returns of these funds have traditionally been lower than the average. Further, the boycotting of sinful companies has had no effect on the offending company's behavior. Cigarette makers still sell smokes, distillers still sell liquor, and casinos will always help people gamble. If the boycotting of their stock ever did happen to have

any effect on its price, it drives it lower and cheaper which will induce buying from other investors without the socially conscious fund company's moral scruples. It is the job of the CEO and the mutual fund manager to increase returns. If the Pure Investor wishes to promote some cause, he'll use the excess returns derived by his sinful investing.

Another mistake made by the Pure Investor was using passively managed mutual funds exclusively. These funds simply attempt to track a common stock market index instead of trying to pick stocks to outperform that index. The Pure Investor did this under the common belief that most managers cannot outperform the Standard & Poor's 500 Index. He also thought he could increase his returns by saving on management fees. Passively managed funds are much cheaper than actively managed funds. However, while a preference for passive management was held for some time, this too proved to be a mistake. In the Spring 1998 *Journal of Private Portfolio Management*, the authors David L. Ikenberry, Richard L. Shockley, and Kent L. Womack published as article called *Why Active Fund Managers Often Underperform the S&P 500: The Impact of Size and Skewness.* The authors found that the underperformance of mutual fund managers compared to the index was due to the size of the companies invested in and the number of companies that a mutual fund held. For instance, as more small capitalization companies were included in the portfolio, the mutual fund managers often did much better than the index. These small companies are a good source of additional return for the average investor. The stocks are more volatile but the payoff is equally increased. Also, if a mutual fund held more companies, its performance often matched or beat the index. Finally, the ability of passively managed funds to outperform actively managed funds seems to be cyclical in nature. The Pure Investor doesn't dismiss passively managed funds completely but he does not rely on them solely.

Buying sector funds has to be the easiest mistake made by a rookie investor. Sector funds are designed to have a very limited scope. For example, a fund may only invest in stocks in the health care industry or the stocks of companies based in Latin America. This is a compromise between buying individual stocks and well-diversified mutual funds. What the sector fund investor is saying is that he isn't smart enough to

pick a good performing individual stock, but he is smart enough to pick an area of the market that will perform well.

Sector funds are one of the best sales tools that fund families have developed. The reason they were developed was to capitalize on the year-in-review reports that fill the financial news. When the newsreader states that technology stocks are on fire, the lemming-like investing public jumps onto the shares in these funds hoping for a quick buck. What the Pure Investor knows, and the average investor doesn't, is that by the time they have heard of the wonders of some particular sector, the money has already been made. Also, because sector funds are not well diversified the returns are extremely volatile. One of the main reasons for buying a mutual fund is to avoid the wild and sometimes random swing in prices that accompany stocks. When an investor buys a sector fund, he is buying these random swings.

What an investor does when he purchases a sector fund is takes the money management out of the hands of the professional money manager and substitutes his own judgement, but still pays for the management. The Pure Investor has to ask himself what is the purpose of that? Giant mutual fund family Fidelity demonstrated its conflicting nature between offering sound advice and making a quick buck with sector funds when it adopted the tagline of "invest responsibly" in its advertising. At the same time, the firm was selling forty-one of its Select Portfolios. These are mutual funds that are not only undiversified, volatile sector funds but they are also priced every hour of the trading day as compared with the once a day pricing of traditional mutual funds. Sector funds are a good marketing tool for the mutual fund companies, but they are a bad investment tool for the Pure Investor.

Another mistake that was costly to the Pure Investor was investing in a large, local company. This is common among investors across the United States. In Atlanta, too many portfolios consist of large, if not sole, positions of Coca-Cola. In Seattle, Boeing and Microsoft dominate portfolios. In Cincinnati, portfolios might consist mainly of Procter & Gamble, and in Houston it was Enron. Except for the last example, these may be ideal companies with good management and a great business plan; however, cliché as it may be, it is still never smart to put all your eggs in one basket.

A common reason cited by investors for investing in large, local companies is that since they are in the same town they know the firm better than anyone on Wall Street could. This is incredible arrogance. For years, workers have been surprised by layoffs, downsizing has stunned middle managers, and CEOs have steered their company suddenly into the ditch. Why would a citizen that has nothing else in common with a company except a zip code have any special insight into its internal operations?

Further, with such large local companies, investor's use the rationale that the firm is so large and diversified and its operations are spread so much around the world that it acts just like a collection of companies. In other words, the company is an ersatz mutual fund. There are too many reasons why this logic is flawed to list in a volume of this size. The Pure Investor can remember off hand several examples on single events that have knocked a large firm off of its feet. New Coke, the Tylenol poisonings, the Edsel, Apple's Lisa, Enron's shredding and Arthur Andersen's accounting.

A continuation of this logic, but more dangerous to an investor's portfolio, is investing in his employer's stock. This has all of the perils of investing in a large, local company. In addition, if the company has a bad period of business, not only does the share price drop, which decreases the investor's net worth, in an effort to raise its stock price, the company may lay him off. This is not only putting all your eggs into one basket, it's also putting in your bacon, toast and coffee.

Not diversifying across money managers is another lesson that the Pure Investor was expensively taught. Mutual fund families have a strong culture to their investment style. They follow it with cult-like commitment. The cult metaphor is not inappropriate because often there is a powerful, dynamic personality leading these firms. If the Pure Investor uses only one fund family he exposes himself to the weaknesses of that particular investment style. The fund managers and analysts of any mutual fund family work in the same building and oftentimes on the same floor. They read the same research. The ride on the same train to work together. They eat the same lunch at the same restaurants together. They go to the same bathroom together. They behave alike and begin to think alike. The Pure Investor needs different investment

managers thinking differently. It's possible for him to have a variety of managers not even in the same city, much less with the same line of thinking. Whether it's Goldman Sachs in New York, Fidelity in Boston, Transamerica in San Francisco, or Janus in Denver, each company has a different and specific philosophy to further diversify the Pure Investor's portfolio.

Investing within the borders of the United States is a daunting task. However, borders don't restrict money. It flows wherever the highest returns are offered. Initially, there was some confusion for the Pure Investor between International funds and Global funds. International funds must invest exclusively outside of the United States. The Pure Investor uses Global mutual funds that are allowed to invest anywhere, including the U.S. Investing outside of America requires additional skill and expense. Not only must a manager evaluate companies based on fundamental and technical information like a domestic fund, he must do so using a foreign language and with accounting standards different from his own. He must also evaluate the information though the lens of exchange rates. It doesn't matter if a particular stock yields wonderful returns if the currency of the investment depreciated against the dollar so much that when the manager sold the stock and converted it to dollars, the returns were wiped out. These added challenges also increase the fund's expenses that are passed on to the investor.

The largest risk that the Pure Investor faces with investing internationally is political. Currently, all but one of the countries in the Americas are democracies. Twenty years ago, a majority were communist puppet states or kleptocracies. North America is uniting into one productive free trade zone. Europe has adopted a common currency and is also attempting to break down walls inhibiting trade and free enterprise, and Communist China is liberalizing its economic controls. Even with peace breaking out all over, turmoil and instability can crop up at any time. When this happens, the manager of a Global fund is able to bring the money home. The International fund manager is hung out to dry along with his investors.

Finally, the Pure Investor walks away from any portfolio manager that wishes to explain to him that he has a new, unique, and previously unfound method of earning returns in the market. Many times these

involve a computer-based model that, when run back through history has produced greater returns with less risk than earned by any other fund. This is usually done by mining data from stock returns for past years and finding a method that would have provided those results. This is similar to tracking how rain fell during a storm and then explaining how a person could have walked a specific pattern to avoid getting wet. The Pure Investor knows that no money manager would have taken the actions necessary to achieve the performance the model predicts without 20/20 hindsight. He further knows that rain never falls the same way twice so the model's uselessness is total.

The Pure Investor Uses an Investment Advisor

THE PURE INVESTOR has repeatedly learned that whether it's an investment manager, a lawyer, a real estate agent, travel agent or a car insurance salesman, a professional advisor who understands his needs will be worth more than any commission or fee that he charges. That said, the reader must bear in mind that the author is a practicing investment advisor and earns his living by convincing people to use his services. The use of an investment advisor will profit anyone who is wishing to participate in the market.

On June 21, 2001, Dalbar Inc., the nation's leading financial services research firm, released its annual "Quantitative Analysis of Investor Behavior." It reported that the average fund retention was 2.6 years. Mutual fund investors didn't have the will power to dedicate themselves to one fund for as little as three years. A mutual fund is by nature and definition a long-term product. Much of the assets are in tax-qualified retirement plans that are not to be needed for years into the future. Their own irresponsible lack of patience has robbed them of substantial returns. This is why there is a big difference between investment performance and investor performance. The average equity-fund investor

realized an annualized return of 5.32% from January 1984 to December 2000. During that same time period, the S&P 500 averaged 16.29%. The average equity-fund investor could have achieved the same return with CDs at substantially less risk. These investors where not using an advisor. They were navigating by stars that were moved randomly. They were spooked by a market correction and sold at the wrong time or, more likely, they were enticed by a sexy return and bought a mutual fund after the returns were made. An experienced, professional investment advisor can help clients maintain their long-term focus, remind them why the fund was chosen originally, and keep them from making common investment mistakes.

Historically, stock mutual fund investments have outperformed bond mutual fund investments. However, without an advisor, investors who buy fixed income bond mutual funds outperformed the investors of equity stock mutual funds with a 6.08% return. These bond investors still trailed the long-term Government Bond Index that yielded only 11.83%. There are two reasons why the results of the investors have been just the opposite of their investments. First, equity investors are scared by the stock markets roller coaster more than the Ferris Wheel bond market scares the fixed-income investor. Second, equity-investors are jumping from hot-fund to hot-fund chasing returns that have already occurred. The Pure Investor thinks the primary job of his investment advisor it to keep his clients from shooting themselves in the foot. Advisors do this in a number of ways.

Stop Panic Selling and Fanatical Buying

The first job the Pure Investor's investment advisor had in the financial industry was as a trader at a large discount broker. For eight hours a day, he would take orders from clients across the country. At the same time each day, Dan Dorfman, a dynamic commentator on one of the financial cable channels, would issue his proclamations as to which stock to buy or sell. The advisor's phone would begin to ring off the hook. Many times, as the client was placing the order to sell or buy a particular stock, the advisor could hear Mr. Dorfman on the TV in the client's living room explaining why everyone should buy or sell a particular

stock. They did not even wait for Mr. Dorfman to finish explaining why the stock needed buying or selling. These were not sophisticated investors. They would panic and not know why. Then they would be disappointed, mad, and frustrated when they didn't get that extra 1/8 of a point price of the stock. This behavior was so bad that the investment advisor started to refer to his job as 1-800-GET-ME-IN and 1-800-GET-ME-OUT. He knew the clients were costing themselves money and the brokerage house was profiting at their expense.

Now, as an investment advisor, his job is to stand between the market's gyrations and the investor's actions. He is a calming influence. He shifts the investor's sight from the short-term ups and downs to the investor's long-term goals. He educates his clients on why the market is behaving as it is and how to take advantage of it.

The adverse, but no less harmful side, of panic selling is fanatical buying. Usually during speculative bubbles, any stock looks great and the investor's fear changes from losing money to missing out on making a quick buck. Some investors will throw money at any company no matter how absurd the business plan as long as they can convince themselves the reason for buying has some conceivable plausibility. Again, the investment advisor steps in and protects the investor from himself by forcing him to pause, think about his long-term goals, and stick with his investment plan.

Manage the Manager

The second duty of an investment advisor is to monitor and assess the behavior and returns of the mutual fund portfolio manager.

On September 11, 2001, David Alger, the premier money manager, and much of his staff were killed in the World Trade Center attacks. The Pure Investor's advisor is the manager of a national broker-dealer branch office with a large amount of money managed by Alger. Early on the morning of the 12th, the investment advisor and other principles of his firm were called for their opinion on who should handle that money and shortly thereafter was told what the Alger firm's internal plans were. They were then able to call the Pure Investor and each of their other clients personally and give them some assurance that they

knew what was going on in that confused, terrible week on Wall Street. The Pure Investor did not panic, he did not sell, and within a few weeks his accounts were at pre-9/11 levels and within a few months the Pure Investor was profiting from his level headedness. Other, smaller investors, those who didn't have an advisor or whose advisors did not demand communication, were left in a cloud of confusion like the one that covered lower Manhattan. They panicked and lost.

As noted previously, during 1996, a relatively prosperous time in the markets, the flagship Fidelity Magellan fund began to list. The public soon found out Jeff Vinik, the large-cap, domestic equity fund's manager had invested heavily in bonds. This choice suppressed their returns as the equity markets rallied and the bond markets stagnated as usual. The Pure Investor and his advisor can remember this well because Magellan had a large portion of their portfolio. It was drilled into their head that these managers needed to be managed. Their quarterly reports must be inspected, their conference calls have to be listened to and you must call their firm with questions.

The Pure Investor doesn't have the clout, time, experience, or knowledge to smell a rat. Only a professional investment advisor who is digging into the details of the industry everyday can acquire the innate sense required to manage the managers.

Manage the Taxes

The returns of the best money manager are irrelevant if Uncle Sam pockets the profits. The Pure Investor's advisor works with his accountant in minimizing the taxes paid which, in turn, maximizes the returns earned. Investors, and many advisors, are not capable of knowing when to use some of the more common ways of deferring or avoiding taxes. When should an investor consider a mutual fund versus a tax-efficient mutual fund versus a variable annuity versus a variable life insurance policy? The average investor doesn't have the resources to entirely comprehend how these products work and where to use them, nor how to manage them once he has bought them. However, each does have an appropriate place in helping the Pure Investor defer and avoid Uncle Sam legally. Using the Four Boxes and the client's risk tolerance and objectives, the

advisor puts the Pure Investor's money where Uncle Sam has been the least hostile with tax policy.

Although the tax code is important, it is not the only place where an experienced advisor can help his clients. Currently, there are a number of plans promoted for college savings and many investors use them on their advisor's advice. Uniform Trusts for Minors Act (UTMA), 529 plans, and Coverdale Education Plans are all designed by Congress to promote college savings. No matter what the benefits offered by these, they might not be as good as simply putting their money in Box Two, Box Three, and sometimes Box Four. The reason is that the tax code conflicts with the federal student aid system. For instance, in years past, advisors would many times suggest to parents interested in saving for college to use the Uniform Trusts for Minors act. This was because the assets in the trust were taxed at the child's income tax rate which is normally much lower than the parents. This is a good strategy to increase returns. However this tax savings can cost a bundle. When the investor applied for financial aid, they failed to realize that the assets of the child are counted much more heavily than the assets of the parents. As of 2001, the family was expected by the college financial aid system to contribute 35% of all the child's financial assets per year towards the cost of college. Parent's assets are taxed at a much lower rate. The student aid system only expects a contribution of 5.6% of their assets. This amount does not include the family home, Box Three, or Box Four. Additional, before any contribution is assessed, the total amount of the parent's assets must be above a certain floor depending on the size of the family and the parent's age.

The Pure Investor doesn't care where his returns are derived. If they come from keeping a dollar that would have been paid to the IRS, he is even more happy and appreciative of the investment advisor.

Leverage Other Professionals

An experienced advisor will be in constant contact with estate lawyers, tax accountants, and elder law specialists. This cross-pollination between disciplines will give the investment advisor an intuitive sense of what is right and wrong. There are a lot of salesmen that will give any

advice that sounds good and makes the sale. A good professional investment advisor will be interlocked with a group of professionals to provide the best advice and services to all of their clients.

This is a key distinction between a salesperson and an advisor. When an advisor is meeting with a client and the conversation reaches the point where his expertise has been exhausted, he is able to call upon the resources of whatever professional is needed to solve his client's particular problem. A salesperson, however, will oftentimes steer his client away from outside resources and attempt to answer any and all questions. He is not worried about meeting his client's needs but about some accountant or lawyer blowing his sale. Again, if the prospective advisor cannot state a CPA or estate attorney they work with, the Pure Investor heads for the door.

Leveraging other professionals is not only good for the client, but also good for the advisor. He can concentrate on his primary responsibility – increasing his client's wealth.

The Pure Investor Interviews an Investment Advisor

THE PURE INVESTOR'S primary concern is not whether to use an investment advisor, but how to choose one. He is convinced that an investment advisor is necessary for any investor who wants to achieve his goals effectively and efficiently. The relationship is intimate. Like a marriage, dreams are discussed, goals established, and weaknesses are challenged. The final choice will be a long-term commitment and any false starts are a delay in the achievement of dreams.

Unfortunately, finding the right person has not been made easy by the financial industry. An investment advisor is anyone who holds himself out to be one or has the title investment advisor on his business card. An investment advisor could be a Certified Financial Planner (CFP), a stockbroker, an insurance agent, a tax preparer, a Certified Public Accountant (CPA), a Chartered Financial Analyst (CFA), a lawyer, or some guy who decides he wants to be an investment advisor and hangs a sign on his door saying so. The field of financial advice has a very low

barrier to entry. There are conflicting laws regarding who can call themselves an investment advisor and how they can be compensated for their work. Furthermore, each state has its own laws. The Pure Investor's job is to select someone from this menagerie with whom he can feel comfortable talking about his most personal financial matters and in whom he has confidence that this person can help him achieve his goals.

The Pure Investor chooses an advisor first by reputation and word of mouth. He asks himself who has been recommended to him. He asks his accountant or lawyer who they trust. He listens to his friends, acquaintances, and relatives describe an advisor that meets his needs. The Pure Investor listens with caution to all of these recommendations, but especially to those of this friends, acquaintances, and co-workers. The person recommended might not be the best advisor, but only the best salesman who has a preternatural ability to connect with people and inspire confidence. When the arrest of a con artist hits the paper, inevitably he has worked his way through a community of family and friends. That said, referrals are still one of the best ways to narrow down the advisors listed in the yellow pages and find someone who can help him achieve his goals.

The best way to narrow down the field is to hold individual meetings with the advisors and ask questions. The Pure Investor is not suspicious and untrusting. He doesn't expect any of the individuals he speaks with to lie or misrepresent themselves, but he still follows the advice of Ronald Reagan when dealing with the Soviets: Trust, but verify.

Licenses, Designations, and Experience

The first question that should be posed to an investment advisor is: "What licenses do you hold?" Securities brokers have two main licenses that they pursue. They are the Series 6 and Series 7. These exams are relatively difficult and are administered by the National Association of Securities Dealers (NASD). The Series 6 allows a broker to sell investment company products; mainly mutual funds and annuities. The Series 7 encompasses the Series 6 but also allows the advisor to broker the purchase and sale of stocks, bonds, and options for his client. The Series

7 is more difficult than the Series 6 but that does not necessarily mean that the advisor with his Series 7 is better than the advisor with his Series 6. This may be a business decision on the part of the advisor. The Series 6 advisor may, like the Pure Investor, be an advocate of professionally managed money and has no interest in trading individual stocks or bonds. The continuing education requirements for securities licensing are minimal. Securities licensing information for any broker can be verified at the website of the regulatory arm of the NASD, *www.nasdr.com,* with the name of the broker and his broker/dealer.

While securities licensing is standardized for all fifty states, insurance licensing is within the realm of each individual state. While many have a reciprocity arrangement where an agent licensed in one state can sell in another, standards are diverse. Many states require some sort of classroom instruction followed by an exam. There are different exams and licenses required for each line of business. For example, an agent who wishes to sell life insurance must pass the requirements of the life insurance exam. He is not able to sell car insurance. That would be another examination process. While the life insurance examinations in many states are easier than the exams of security licenses, the continuing education requirements are more extensive. Many require 20-plus hours of classroom study within a two-year period. The status of an advisor's license can be easily found on many states' department of insurance websites or by calling the department of insurance directly.

The Pure Investor believes that his advisor should be securities and insurance licensed so he can not only develop a complete financial plan but also execute it and then monitor it in the years to come.

Designations are pursued by many advisors not only for the educative value, but also as a symbol to other professionals who they work with that they are serious professionals themselves. Certified Public Accountants (CPA) and attorneys are very protective of their clients and do not want their reputations damaged by an investment advisor who does not meet their standards of professionalism or education. The designation communicates the same message to the Pure Investor. The designation the public is most conscious of is the Certified Financial Planner (CFP) designation. It is an intensive multi-year program that educates the would-be advisor and forces him to examine every aspect

in the financial planning process. The two other designations that the Pure Investor sees the most are the Chartered Life Underwriter (CLU) and the Chartered Financial Consultant (ChFC). The CLU deals mainly with life insurance, which is extremely important to the Pure Investor. The ChFC covers the same information that the CFP does, but takes on some additional requirements focusing on life insurance. Finally, the Chartered Financial Analyst (CFA) designation is considered one of the most prestigious within the financial community. It is a rigorous and grueling three-year examination process focusing on investment valuation, portfolio management, and asset allocation. Professional money managers at mutual funds and trust departments pursue this designation. So too does the advisor who wishes to understand the esoteric and complicated aspects of the mechanics of the investment process. The Pure Investor sees this as a built-in exaggeration detector. The CFA designation makes it just that much harder for a money manager to pull the wool over his advisor's eyes.

Finally, the investment advisor's experience must be examined. The Pure Investor needs to know if the advisor has been in the business long enough to experience many of the fads and foibles within the financial industry. Did he live through the last bear market and feel the pain of watching portfolio values slide away? Is this someone dedicated to his job or someone who has had a mid-life career change and may have another?

While licenses, designations, and experience are the mark of a professional, they do not tell the whole story. The Pure Investor still has questions.

Fees versus Commissions

The first question many people have when working with an advisor is how that person gets paid. This is the fee versus commission debate. The Pure Investor is indifferent to how the advisor is compensated as long as the advisor is fulfilling his professional and fiduciary duty to provide him the best advice and counsel.

While it is almost accepted common knowledge that a commission based investment advisor is not looking out for the client's interest, the

Pure Investor does not accept this belief. First, a commission is an advertising cost to the mutual fund or insurance company. If it doesn't pay a sales force of advisors to move their product, the company has to advertise in the mass media where client loyalties are harder to maintain and it is more difficult to verify the right people are buying the right product. Second, when an advisor buys a mutual fund for a client, he often receives an up-front commission. What is not commonly known, however, is that the advisor also receives what is called a trailing commission. This is a sum paid every year to the advisor by the mutual fund or insurance company to continue servicing the client. The trailing commission is based on the net value of the assets the advisor has under management for his client and is taken from the expense charges of the fund. What is beneficial to the Pure Investor in this instance is that the advisor has a vested interest in growing his portfolio. Essentially, the larger the investment grows and the greater the return, the larger the advisor's trailing commission. The advisor has a strong incentive to keep working with the client year after year to keep receiving the trailing commission.

Fee-based planners are becoming much more popular lately because of the notion that they provide more objective advice. The one important difference is that the Pure Investor will have to write a check to the advisor himself instead of a mutual fund or insurance company compensating him. Most often, the advisor does not receive trailing commissions. This severs the link between the value of the Pure Investor's portfolio and the advisor's compensation. While the Pure Investor doesn't believe a fee-based planner is more objective, he doesn't much care how the advisor is paid. If he thinks the fee-based advisor is more qualified and attentive to his concerns, he will use him, but he will just as well use a commission compensated advisor.

The Investment Advisor's Practice

One of the crucial elements of working with an investment advisor is communication. The Pure Investor has an expectation that his advisor has a system to regularly and consistently communicate with his clients. Annual meetings are a requirement with at least several contacts between annual meetings.

Another important question is where the advisor derives his income. The Pure Investor wants someone who is focused on the investment advisory business with a bias towards equity investments. Things that would be suspicious are someone who sells a lot of whole life insurance, fixed investments, or auto insurance. Doubt should also be raised if the advisor is working as an advisor as a sideline with a full-time job somewhere else.

Finally, the Pure Investor asks for references from the advisor's current clients. If the advisor has a first-rate practice where he has helped people achieve their goals he will have developed cordial and friendly clients who will be happy to speak with anyone for his benefit. Also, the Pure Investor asks for the names of attorneys and accountants that the advisor works with. A professional advisor develops many contacts in the course of his business and attorneys and accountants are some of the most important.

None of the information obtained during the one or two hours spent interviewing an advisor is of any value if it is not checked. Remember: trust, but verify. The Pure Investor called each reference, contacted each regulator, substantiated each designation, and checked out each claim. Choosing an investment advisor is one of the most important decisions made by an investor. It is worth taking the time to make preparations before entering into a new relationship.

Conclusion

IN THIS SMALL, slight volume I have shown you, as promised in the first paragraph of this book, how the Pure Investor views the world and what actions he takes to increase his wealth. The interconnection between the economy, politics, investing, and the markets is not a system that always functions with logic and precision, where a flaw can be diagnosed and corrective actions taken. The world of investing is tangled up with the world of imperfect and irrational human beings. The mind of the artist is needed more than the mind of the engineer. In economics, two plus two sometimes equals five. A dollar put into the market can become a quarter or grow into a fortune. As Todd Buchholz writes in his wonderful book "New Ideas from Dead Economists:"

> "Economics is not, as Adam Smith and some of his rationalist successors tried to depict, a science of precise laws. Tendencies, maybe. Higher output means lower prices, except when Veblenesque goods enter the scene. A higher money supply usually means lower interest rates, except when fears of inflation push interest rates higher. Stock prices usually represent rational predictions of future cash flows, except when "animal spirits" panic or excite investors

> into dramatic swings. Investors usually take risks until the marginal benefits equal the marginal costs, except for Schumpeterian *ubermensch* entrepreneurs, who perceive values better than the market."

The Pure Investor is a man dedicated solely to the growth of his assets. To do that, he throws off the requirements placed on him by society. He does not allow any person or institution or tradition to dictate to him how he should use and view his money. He uses the advice of professionals, he builds a well-allocated portfolio of equity mutual funds, he learns from his mistakes, he is true to himself and in the process he becomes wealthy and secure. In doing so, even though he started with no interest in it, he has improved the world for all.

Summary

THE PURPOSE OF this summary is not to encourage the reader to bypass the entire text and simply get a faint sense of the book like a high school junior buying *Cliff's Notes* instead of reading *The Grapes of Wrath*. Its purpose is to allow the individual who is striving to become a Pure Investor to stiffen his courage after it is shaken. Even those who agree wholeheartedly with the principles put forth by the Pure Investor can become lost at times. The Pure Investor often did. At sometime in the future, the investor will be accused of greed because of his concern for his returns and his anger at paying more taxes; he will be filled with worry when the market is down and it seems his assets are shrinking while his bond investor friends are treading water; he will be consumed with greed and be tempted to deviate from the Pure Investor's principles and jump at a possibly extraordinary return. At those times, it is hoped that the reader will revisit this section, be reminded of why he followed the Pure Investor's advice in the first place, and stick with his original plan. Not getting sidetracked is the key to long-term wealth.

Tuesdays with The Pure Investor

The Pure Investor was a teacher and friend. He had a disciplined mind that was able to shut out the static in society and focus on his

returns. Over his lifetime he was able to identify certain principles to live by and he did.

Strict adherence to the positions put forth over the pages of this little book will, over the course of a life, yield a profitable and secure life. This is the ultimate freedom of the Pure Investor.

Views of the Market

Much of the static that the Pure Investor was able to shut out came from four basic groups identified below. Each offered society and the investor class solutions to the troubles of our economic system. Each solution, when tried, has failed. Some have decimated a society, others only parts of a society. The Pure Investor discards much of what they have to say. The only proven solution to a country's problems is unbridled capitalism. It is painful at times, but the damage is short term and the rewards are high.

The Politician

The Pure Investor agrees with Groucho Marx's perception that "politics is the art of seeking trouble, finding it everywhere, diagnosing it incorrectly and applying the wrong remedies." The politician attempts to place himself between natural market forces and the citizens. This only masks, exacerbates, and lengthens whatever problem the market is trying to tell to the people.

Also, many of the economic problems of the twentieth century were caused by government interference. Government's answer to the problems it created was more government. The Great Depression was one example he gave.

The Pure Investor knows that most government policies are a detriment to his profits and returns. He knows that the proposed cures are worse than the disease.

The Chief Executive Officer

In a capitalistic society, the CEO who provides his stockholders

with good returns is placed on the same mantle as war-winning generals and child-rescuing firemen. The Pure Investor always keeps in mind that a successful CEO is good, and possibly fortunate, at running a company, but often knows nothing about running a successful country.

A profitable company often needs a strong hand on the helm with orders obeyed from the top. A free, capitalistic economy needs just the opposite. A country works best when each individual is allowed to make choices for themselves in their best interest.

The Church

Mainstream churches often encourage the investor to sacrifice himself for his fellow man. It asks this for the noble goals of alleviating poverty and lifting up the spirit of all. However, socialist countries have already implemented the prescriptions they suggest. The results have shown to be depressing. The Pure Investor knows the best anti-poverty program available is pure, unvarnished, unblunted capitalism.

The Media

The Pure Investor knows the job of the media is to sell advertising. To do this they offer up hysteria, euphoria, and paranoia. This gets eyeballs looking at the newspaper or the television screen. In order to avoid an emotional roller coaster and to stay focused on his long-term investment goals, the Pure Investor is selective in what outlets he exposes himself to.

The Pure Investor

The Pure Investor views free financial markets as the end result of Western Civilization's pursuit of freedom in all of its forms. He knows that this freedom is derived from the protection of Property Rights, the Rule of Law, and Democracy. Much of the long-term rising and falling of the market can be traced to an infringement of each of these values. These three are the basics. Without them a country will fall to third world status.

The Five Taxes

The Pure Investor defines a tax as any reduction in his worth or income directly caused by the government. He also knows that each marginal increase in taxes is a chipping away of the principles of Property Rights, the Rule of Law, and Democracy.

Tax One – Direct Taxes

This is the most visible tax and causes the most visible problems. Along with class warfare, it dramatically lowers the Pure Investor's returns. It was shown how with a simple investment in a stock a single dollar is taxed a minimum of four times. Income taxes, payroll taxes, capital gains taxes, corporate taxes, taxes on dividends, and sales taxes are all examples.

Tax Two – Trade Restrictions

These restrictions are often imposed to benefit one industrial or geographic sector at the expense of the rest of the country. They have never made economic sense. Their only reason for existence is as a gift given by politicians. Each restriction increases the cost of production thus lowering returns. Property Rights are impinged when a government tells a firm or citizen what property it can and cannot buy and from whom.

Tax Three – Immigration Control

Just like restrictions on steel, computer chips, and textiles, any restriction on labor increases the cost of production to companies and lowers the Pure Investor's returns. Again, freedom is curtailed.

Tax Four – Regulation

The cost of each regulation is another lowering of the Pure Investor's returns and an encroachment on the regulated's Property Rights.

Regulations and their unintended consequences spread throughout a society like tentacle strangling the productivity and vibrancy out of the economy. Regulations cause scarce money to be spent on more accountants and lawyers that don't add any economic value, but only ensure compliance with government mandates.

Tax Five – Inflation

Inflation is an insidious tax. The Pure Investor knows that most people over the age of 55 paid more for their last car than their first house. Inflation, whether intended or not, is caused by government manipulation of the money supply. It alone is a tax on the Pure Investor's returns. When married with the tax code, it yields bracket creep that can decimate an individual's fortunes.

Before The Pure Investor Entered the Market

The Rule of 72 says that an interest rate divided by 72 equals the number of years it takes money to double. For example, $10,000 invested at 12% will become $20,000 in 6 years (12/ 72 = 6).

The Pure Investor Steps into the Market

The Pure Investor doesn't follow the traditional approach of holding a mixture of stocks and bonds. He follows the dictum: "Buy stocks to get rich. Buy bonds to stay rich." Investors are rewarded more by owning a company rather than by loaning it money. Too many individuals fear losing money when they should be concerned about running out of money.

The Pure Investor also invests in mutual funds. The advantages of professional money management, instant diversification, and a fund family structure far outweigh any disadvantages.

The Four Boxes

To simplify and categorize his investments among the many tax and

legal structures available, the Pure Investor divides his money into four convenient boxes. In Boxes Two through Four, he uses mutual funds.

Box One – Ten-Minute Money

This is the Pure Investor's emergency money that he keeps in a savings account or money market. It offers low returns, but high liquidity. It is also fully taxable.

Box Two – Taxable

This is the Pure Investor's money saved for intermediary goals. These are individually or jointly registered mutual funds. It offers good returns, high liquidity, but is fully taxable.

Box Three – Tax Preferred

This box is variable life insurance. It is used for intermediate as well as post-retirement goals. It offers good returns, semi-liquidity, and is tax deferred. The investor must be insurable and must play by the IRS's complicated rules. For this reason, the services of a professional advisor are a must.

Box Four – Tax Deferred

This box is the Pure Investor's retirement funds. It includes his IRAs, company plans, and variable annuities. It offers good returns, is tax deferred, and may also be pre-tax. However, it is illiquid before the age of 59 ½.

The Pure Investor Builds a Mutual Fund Portfolio

The Pure Investor doesn't follow the traditional advice of asset allocation that uses a mix of bonds and stocks with an increasing portion allocated to bonds as he ages. Instead, he allocates his funds across

several equity sectors. He uses mutual funds focused on small, medium, and large companies *(market-cap diversification)* also using growth and value stocks *(style diversification)* and finally a portion to global companies *(geopolitical diversification)*. As time passes, he allocates more of his portfolio to mutual funds focusing on larger, dividend paying companies.

Think Long-Term

The Pure Investor knows that the all-equity portfolio is more volatile than a traditional portfolio. However, over the long-term, equities are the only investment that can overcome The Five Taxes and advance the Pure Investor's standard of living.

When to Sell a Mutual Fund

Once a good mutual fund has been chosen, it should only be sold when the investor's objectives have changed, the portfolio manager has been replaced, or if the mutual fund has changed its objective.

Learning from the Pure Investor's Mistakes

The Pure Investor has learned not to invest in 1. socially conscious funds, 2. solely in index funds, 3. sector funds at all, 4. the individual stock of a large, local company, 5. his employer's stock, 6. in international mutual funds (but he does use global funds), or 7. in any mutual fund that has developed a new and novel technique to making excess returns that no other company has ever conceived. One important thing he does do is to diversify across money managers.

The Pure Investor Uses an Investment Advisor

There is a big difference between investment performance and investor performance. An investment advisor can be the key to unlocking a prosperous future. An investment advisor provides several services.

Stop Panic Selling and Binge Buying

The investment advisor places himself between the investor and his emotions. When markets are down, the investor will want to flee the market. When markets are soaring, the investor will want to throw his money at any promising hot stock. The investment advisor steps in at these times. He protects the investor from himself by forcing him to pause, think about his long-term goals, and stick with his investment plan.

Manage the Manager

The advisor monitors the portfolio manager's behavior to make sure that the mutual fund purchased by the investor remains what was purchased. If the Pure Investor needs a large cap value stock fund, it is the advisor's job to make sure the mutual fund stays a large cap value stock fund.

Manage the Taxes

Finally, it is the advisor's job to make sure the mutual funds and the legal and tax tools (the four boxes) used are the most tax effective for the Pure Investor. A mediocre mutual fund can appear to have sparkling performance if the taxes are managed correctly.

Leverage Other Professionals

Many times the investment advisor's field overlaps with that of attorneys, accountants, and insurance professionals. The good investment advisor will know when to bring these professionals in for the benefit of his client.

The Pure Investor Interviews the Investment Advisor

Choosing an investment advisor could be one of the most important and consequential decisions made by the Pure Investor. He must ask plenty of questions and verify each of the answers.

Licenses, Designations, and Experience

The Pure Investor believes that his investment advisor should be securities and insurance licensed so he can not only develop a complete financial plan but also execute it and then monitor it. Any designation and experience the advisor has is only beneficial and weighs heavily in the investor's decision. Each of these items must be verified. Through the Internet and well-placed phone calls, this can be done easily.

Fees versus Commissions

The Pure Investor doesn't care how the investment advisor makes his money as long as his interests are placed first.

The Investment Advisor's Practice

The Pure Investor identifies where the investment advisor derives most of his income. Unfortunately, there are few barriers to entry into the field and any person can call themselves an investment advisor. The Pure Investor makes sure that the advisor focuses exclusively on the financial markets.

Sources

AS AN ANONYMOUS graduate student once said "To steal ideas from one person is plagiarism, to steal ideas from many is research." *The Pure Investor* is not an academic work. A practicing investment advisor wrote it. Its purpose is to fortify and reaffirm the natural instincts of individuals who fall victim to fashionable and counterproductive beliefs of society and to instruct them on the right actions to take to increase their wealth. For that reason, the citations included below do not conform to academic standards but will give the reader whose interest was peaked on a specific topic a starting place for further reading. The thoughts and opinions in this book have their roots from several sources. I am indebted to those listed here and many others for their indirect contributions.

Views of the Market/*The Politician*

The section detailing the time line of the Depression is taken from the work of Milton Friedman, especially *Free to Choose* which he co-authored with his wife, Rose, as well as the author's own economic and financial education.

Information regarding whether a recession occurred in 2001 or

not can be found at the National Bureau of Economic Research's website at *www.nber.org*.

Also, an interesting discussion regarding this non-event can be found at www.foxnews.com/story.0,2933,47464,00.html.

Views of the Market/*The Chief Executive Officer*

Details of Henry Ford's ill-fated "Peace Ship" cruise are detailed in *The Fords: An American Epic*, by Peter Collier and David Horowitz.

Mr. Iacocca's books are: *Talking Straight* by Lee Iacocca with Sonny Kleinfeld & *Iacocca: An Autobiography* by Lee Iacocca with William Novak

Views of the Market/*The Church*

The statement by the National Counsel of Churches regarding the tax cut can be found at www.ncccusa.org/news/01news33.html. The NCC's tax rebate request can be found at www.ncccusa.org/about/taxrefund.html.

The full text of "A Social Statement on Economic Life: Sufficient Sustainable Livelihood for All" issued by the Evangelical Lutheran Church in America (ELCA) can be found at www.elca.org/dcs/economiclife.pf.html.

Views of the Market/*The Pure Investor*

Free Copies of the Declaration of Independence and United States Constitution can be ordered from the Cato Institute at www.cato.com

Details regarding Castro's confiscation of U.S. property can be found in the Heritage Foundation's policy analysis written by Bryan T. Johnson at www.heritage.org/library/categories/forpol/em441.html

The gross domestic product of the Middle Eastern nations can be found at www.encarta.com.

The well-written story by Casey Jones of the Medill New Service regarding the Lake Tahoe building moratorium can be found at www.medill.nwu.edu/docket/00-1167fx.html.

The Heritage Foundation/Wall Street Journal Index of Economic Freedom is updated yearly at www.heritage.org/index and can be purchased directly.

The Five Taxes

Data on the Irish computer industry can be found at www.corporateinformation.com/iesector/Computers.html

The Five Taxes/*Tax One – Direct Taxes*

Information on Tax Freedom Day is compiled by the Tax Foundation. Their website is www.taxfoundation.org/taxfreedomday.html

The Five Taxes/*Tax Two – Trade Restrictions*

The study conducted by the Consuming Industries Trade Action Coalition was entitled "Costs to American Consuming Industries of Steel Quotas and Taxes." It can be found on the coalition's website at www.citac-trade.org.

The Five Taxes/*Tax Three – Immigration Control*

Herbert Hoover's Rugged Individualist speech can be found at http://coursesa.matrix.msu.edu/~hst203/documents/HOOVER.html. It is a classic expression of Americanism unfortunately overshadowed by the economic calamity that shortly followed it.

The National Research Council's study of U.S. immigration *The New Americans: Economic, Demographic, and Fiscal Effects of Immigration* can be ordered for $55 from the National Academy Press at 202-334-3314. Their website is www.nationalacademies.org.

The Five Taxes/*Tax Four – Regulation*

Information on the cost of workplace regulation can be found at www.mercatus.net. The study referenced in the text can be located under the *Regulatory Studies* tab.

The Five Taxes/*Tax Five – Inflation*

Any of the works of Milton Friedman are useful for information regarding inflation and its effect on the markets and society. Especially entertaining is his *Money Mischief: Episodes in Monetary History*.

Before The Pure Investor Entered the Market

The Rule of 72 is often attributed to Albert Einstein. The most dramatic version of this story has him being asked on his deathbed what was his most important discovery. He supposed response was either "Compound interest" or "the Rule of 72." This story and any other version of it is a complete fallacy.

The Pure Investor Steps into the Market

The *Financial Services Review* along with the article S*trategic Asset Allocation for Individual Investors: The Impact of the Present Value of Social Security Benefits* can be found on the Review's website at www.rmi.gsu.edu/fsr/fsrhome.htm.

Wiesenberger® InvestmentView provided mutual fund return data.

The Four Boxes/*Box Three – Tax-Preferred*

Information regarding industry breakdown of campaign giving is found at The Center for Responsive Politics website at www.opensecrets.org/lobbyists/index.asp

The Pure Investor Builds a Mutual Fund Portfolio

Seabiscuit's story can be read in *Seabiscuit: An American Legend* by Laura Hillenbrand.

The Callan chart can be downloaded from the Callan Associates website at www.callan.com

The Pure Investor Builds a Mutual Fund Portfolio/*Think Long-term*

Current and historical life expectancy statistics can be found at the Centers for Disease Control and Prevention's National Center for Health Statistics website at www.cdc.gov/nchs/fastats/lifexpec.htm.

The Pure Investor Builds a Mutual Fund Portfolio/*Learning from the Pure Investor's Mistakes*

Contact information for the *Journal of Private Portfolio Management* can be found at www.iijournals.com

The Pure Investor Uses an Investment Advisor

Information regarding Dalbar's Quantitative Analysis of Investor Behavior can be found at www.dalbarinc.com.

Conclusion

The quote used from Buchholz's *New Ideas from Dead Economist* is the most concise observation of the market's contradictions and why the mind of the engineer will always be baffled by it. However, two explanations are required.

A *Veblenesque good* is a product whose price doesn't go down when a larger quantity is available. They are goods whose price is determined by the prestige value they bring to the owner. Examples include SUVs made by Cadillac and Mercedes-Benz that are just as good as a Jeep. Other items include Gucci bags, Rolex watches, and high priced clothing with the designer's label emblazoned on the outside.

Joseph Schumpeter was one of the 20th century's most preeminent economists. His *ubermensch* entrepreneurs were those innovators and leaders who jumpstarted a beleaguered economy to growth. Schumpeter believed these individuals were more responsible for economic progress than most government policies ever could be.

Recommended Books for Further Reading

FREE TO CHOOSE by Rose and Milton Friedman is a powerful document that details how freedom in the United States has been undermined by burdensome laws, increasing regulations, and excessive taxes. Written in 1979, the examples are somewhat dated but the principles are timeless. It is an easy and informative read. There was an accompanying television series by the same name that is also great. It can be purchased at www.laissezfairebooks.com.

Parliament of Whores and *Eat the Rich* by P.J. O'Rourke are raucous and hilarious looks at government operations and the dismal science of economics. Mr. O'Rourke's writing is more educational than any textbooks. They are more humorous than books on government and economics should be allowed to be.

The Road to Serfdom by Friedrich von Hayek is a serious and devastating work. Hayek lived in Germany as a young man and then immigrated to England and the United States. His central thesis is that the collectivist policies implemented in the late 19th and early 20th century naturally led to the rise of the Nazis. His thesis further continued that

these same policies advocated by the Socialist in England and the New Dealers in the U.S. might cause the same horrific outcome.

The Wealth of Nations by Adam Smith was written in the same year as the Declaration of Independence and was an economic version of the same philosophy. It is the only truly indispensable economics text in the field. Its breadth is astonishing and is still highly readable 225 years later. The Wealth of Nations covers every individual's role in a vast society. In it Smith argues and proves that wealth is created by an unregulated, free market system with a minimum of government intrusion.

New Ideas from Dead Economist by Todd Buchholz is a survey of economic thought from Adam Smith to the present day. A short book, it is breezily written but crammed pack full of history and economic theory. It is the best book to recommend to someone at lunch having dinner with a group of economics professors that night.

Atlas Shrugged and *The Fountainhead* by Ayn Rand are long, heavy novels that illustrate fictionally what the Pure Investor knows factually. Each is the story of an individualist's fight against economic and political oppression that in reality is the hero's fight for his own Spirit.

Appendix: Two E-mails from the same client

THE FOLLOWING TWO e-mails have been included as examples of investor psychology and the benefits of using an investment advisor. They are adapted from actual e-mails during late 1999 and mid-2002.

E-Mail One

– Original message –
From: *HappyClient@work.com*
To: Howard McEwen, CFA
Date: Just before the technology bubble burst
RE: Fund Performance & Early Retirement??????

Howard,

I just got my statements and it looks like the funds are doing O.K.

I am a little concerned about their quality. The funds of a guy I work with earned an average return of 40+ percent. By my calculation, the funds I have only did in the mid-thirties. Do we need to make a change?

Also, I know when we first meet that I optimistically said I'd like to retire at 60 if possible, but looking at the market these days, I think I'd like to move that up to 55 or sooner.

Thanks

HappyClient

– Reply –
To: *HappyClient@work.com*
From: Howard McEwen, CFA
Date: Just before the technology bubble burst
RE: Fund Performance & Early Retirement??????

Dear HappyClient,

I know I did a good job educating you regarding the markets, but I think we need a refresher course.

First, you have good money managers and it is not wise to try to chase returns of hot funds. If you get the individual names of the funds your co-worker owns, I can give you a more complete answer, but we allocated the funds based on *your* goals and *your* time horizon, *not* your co-workers. We can always find a better performing fund. Many times, these are the laggards the following year. We have chosen good money managers who will pass the test of time.

Second, as far as retiring earlier. If you truly wish to do this, we should meet immediately. You may need to increase how much you are saving to meet this new goal. If you are only thinking of this because you are extrapolating this year's great returns into the future, you should keep

in mind what I said at our first meeting. Equity returns historically average 12%. These are not typical times. A bear market will come someday in the future and you'll have to give back some of these returns.

As we walk towards the future and go up and down these hills of the market, keep your eyes focused firmly on your goals.

Sincerely,

Howard McEwen, CFA

E-mail Two

– Original message –
From: *MadClient@work.com*
To: Howard McEwen, CFA
Date: After the technology bubble burst
RE: Fund Performance & Early Retirement??????

Howard,

Do you know what you're doing?

I just received my statements and I'm losing all my money. The way things are going, I'll never be able to retire.

Sincerely,

MadClient

– Reply –
From: Howard McEwen, CFA
To: *MadClient@work.com*
Date: After the technology bubble burst
RE: Fund Performance & Early Retirement??????

Dear MadClient,

I don't see any reason to sell. If the stock market looked good before the technology bubble burst, it looks great now. All prices have been slashed!

Keep four things in mind:

First, these are not your prices. You are not retiring for a couple of decades. You should be concerned with where prices are at decades from now. Why do you care what the market is doing today?

Second, let's not second-guess the portfolio manager. He is a professional at managing the assets and making the choices. He has tremendous resources. Let him do his job. If he wants to go to cash, he can and will. However, if we sell our funds and go to a money market, he's not going to call us when he sees the market about to take off.

Third, this is the time to buy into the market. I'm in the only business where prices are marked down and people run away. If the grocery store or car dealer drops their prices, people run to them. A down market is an opportunity, let's take advantage of it.

Four, I know you still need to sleep. Let's set a time to get together and review market history during similar times. Knowledge and education will put your mind at ease.

Sincerely,

Howard McEwen, CFA