



Chapter 3: SWANs Plug Leaks Before They Fill Buckets

Imagine that you were about to watch a horse race, and you had to pick the winner between two of the horses. One of them was called Old Nelly and the other was named Secretariat. Both the horses had good track records, but Secretariat clearly had performed better in the past. Armed only with that information, undoubtedly you would choose Secretariat, the horse with the better performance history, to be the winner. The problem is that there was one more vital piece of information that you were not aware of.

You see, Secretariat was actually at a distinct disadvantage, for while Old Nelly had a jockey riding her who weighed 85 pounds, the horse that you were betting on was being ridden by a man who had just retired as an offensive lineman for the Green Bay Packers to begin his second career ... as a 320 pound jockey.

Like in horse racing, investment decisions should be based in part upon performance history, but not on performance history alone. Like the 320 pound jockey who inevitably dooms his horse to mediocrity, if your financial world is weighted down by excessive fees, taxes, interest on debt and badly done insurance arrangements, you could be dooming yourself to a very disappointing financial future and a needlessly stressful financial present.

In this chapter, we will explore ways to strategically put your jockey on a diet.

So much of the emphasis in today's investment world is based entirely upon performance, about filling your financial bucket with as much money as you can as fast as you can. Unfortunately, the bucket most of the time has leaks that drain it almost as fast as you fill it. By plugging the leaks first, more of your money will continue to work for you and as you will soon see, by eliminating the "lost opportunity cost" of the money that had needlessly been pouring through easily repaired holes in your financial bucket, you can create profoundly more wealth in your lifetime without having to take on the level of risk (and stress) you otherwise would have needed to in order to achieve the same level of wealth.



Three Types of Money

There are basically three types of money that factor into our ability to create wealth: Our lifestyle money, our invested money and our GWIB (I'll explain that one in a minute) money.

Our lifestyle money is the money that we are using to live on. It is what gives us the ability to keep a roof over our heads and food in our bellies, to be able to take our spouse out to dinner and our children on a vacation.

Our invested money is the money that we have in savings account, our 401(k) account, our IRAs and our brokerage account. Some of those accounts may be in high risk investments and some in lower risk, but the goal with this money is to leave it alone to grow for some future purpose, such as retirement or a child's education.

Most financial planners will begin their discussions with you by addressing one of those first two types of money, either encouraging you to save more of the money that you have been spending or by pursuing higher rates of return on the money you have been saving. I begin my discussions with clients by talking about the third type of money ... your GWIB money.

You are probably thinking at this point that you have never heard of GWIB. There's no need to go to a dictionary to look for the word because I made it up. That being said, GWIB is to be sure a four letter word, both literally and figuratively. It is a destroyer of wealth that must be taken on if you are to reach your full wealth creating potential. GWIB is an acronym for Government, Wall Street, Insurance Companies and Banks ... four institutions who through taxes, fees, premiums and interest are the major holes in our financial buckets. Plug these holes and our wealth creating potential soars like a Swan (normally I would say eagle, but this is a book about Swans after all). Fail to plug these holes and we are forced to try and make up the difference by taking higher levels of risk to pour more money into our leaky bucket.

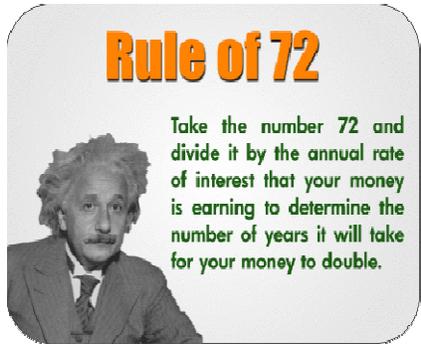
Lost Opportunity Cost



Lost opportunity cost can be the most significant factor in your building a future that will give you the level of financial autonomy that you seek for yourself and the type of legacy that you desire for those you love. Lost opportunity cost is defined simply as what the money that is being lost by pouring out the holes in your financial bucket would have grown to over time had it not spilled out to be lost to you forever. One economist put it this way: "The opportunity cost of using resources in a certain way is the value of what these resources could have produced if they had been used in the best alternative."¹

Not to get off on an anti-smoking commercial here, but one way to illustrate lost opportunity cost (and perhaps persuade a young person not to smoke) is to consider that if a young man started to smoke 2 packs of cigarettes a day at age 20 at a cost of \$4 per pack, he will have spent a total of \$131,400 on cigarettes by the time he was 65. If, however, he would invested the money he spent each year on cigarettes in an investment earning an average of 6% interest per year, he would have had a total of \$673,054 at retirement age. If the investment would have grown at 7% per year he would have had \$926,976, and at 8% a total of \$1,290,257. I don't know about you, but those numbers might be a more powerful stop-smoking tool than a nicotine patch!

Albert Einstein once said that the 8th wonder of the world was compound interest. It is an amazing thing to observe what money can do with even a modest rate of return given enough time.



There is a principle called the rule of 72 that demonstrates the power of compound interest over time. The way that it works is that if you divide the number 72 by the rate of return you are earning on the money, the number you're left with is how many years it would take for your money to the. For instance, if you were earning 6% rate of return on your money, you would divide the number six into the number 72. I know it's probably been awhile since you sat in high school math class, but I suspect you have already calculated that with a 6% rate of return your money would double every 12 years.

Let's look at an example. Bob and Jane have \$100,000 that they leave alone to grow a 6% rate of return for 36 years. Because their money would double every 12 years, they would experience a "triple doubling" over the course of that time period. \$100,000 would double to \$200,000, which would double to \$400,000, which would double to \$800,000.

Unfortunately, it is not quite that simple. Because of lost opportunity costs, money rarely is able to grow to its full potential. If along the way Bob and Jane are paying investment fees and taxes as their money grows, they not only experience the outflow of fees to their broker and taxes to the IRS, they also lose the value of what those lost dollars would've grown to over time. For instance, if they would've paid a 5% upfront sales charge of \$5000 to their broker when they invested their \$100,000, 36 years later their account would've only grown to \$760,000. Their total fee was \$5000, but they're lost opportunity cost was another \$35,000. As you will see in the pages that follow, a \$35,000 lost opportunity cost is small potatoes compared to many of the other common leaks in your financial bucket that I will help you identify and then help you to plug.

To get our arms around the concept of lost opportunity cost and how it impacts our financial future can transform the way that we think about money. As you will see in the pages that follow, there is far more wealth waiting to be created by plugging the leaks in your financial bucket than there is in frenetically trying to pour more and more money into the bucket with higher and higher levels of investment risk. In many cases, hundreds of thousands of dollars can be recovered and put to work for you over your lifetime.

The pages that follow we're going to look together at four common lost opportunity costs that are dramatically eroding your wealth and how you can recapture those costs and put them back to work for you. The focus will be on the four GWIB Wealth Destroyers that we spoke of earlier: Government, Wall Street, Insurance Companies and Banks. In later chapters we will discuss some growth strategies that can help you pour more money into your financial bucket, but for now let's plug those leaks!

GWIB Leak #1: Government

GWIB is a four-headed monster, and the first and most fearsome of those heads is government, specifically the ability of the government to tax our hard earned money. We are taxed today coming and going ... coming, as we make our way through life and pay income taxes, capital gains taxes, Social Security taxes, Medicare taxes, sales taxes, and going as we (or rather our heirs) pay estate taxes as the time of our death. (Our founding fathers started a revolution around the theme, “No taxation without representation. Perhaps with the estate tax we should make our theme, “No taxation without respiration!”).



I saw a bumper sticker once that said well: “If 10% is good enough for God, then it ought to be good enough for Uncle Sam.” While a 10% tax rate might be asking for too much, it sure would be nice to pay less in taxes than we currently do. Every year it seems to get worse. Tax Freedom Day is the day each year we would have paid Uncle Sam everything he was due if we paid the government all of our taxes for the year before we could keep any of our own money. In the year 2010, Tax Freedom Day was estimated to be April 9th ... meaning that you would've worked the first 99 days of the year for the government and would have only begun to work for yourself on day 100!²

There are two types of people who complain about paying taxes: men and women. From our founding fathers who got more than a little upset over a tax on tea right up until the present day, we Americans have always had an aversion to paying taxes. The question is, is there anything we can do about it? The answer to that question is a resounding yes!

The famous US appeals Court Justice the Honorable Learned Hand once said, “There are two systems of taxation in our country: one for the informed and one for the uninformed.”³ How much we pay in taxes as well as in lost opportunity cost on those dollars depends upon how well informed we are about lowering our taxes and what we choose to do with that information.

Let's look together at 3 tax traps that can profoundly enrich Uncle Sam while impoverishing you. Plugging these 3 holes in your financial bucket and then putting those dollars saved to work for you could make a huge impact on the amount of wealth you will build (and keep!) over the course of your lifetime.

The Savings Tax Trap

When we save money in interest bearing accounts, the institution that we are putting these funds in (typically a bank) pays us an interest rate. Every January the Bank then sends us a New Year's gift ... an IRA tax form called a 1099. This form shows how much interest we earned in the previous year, and we then place that total on line 8a of our tax form and pay taxes on it as ordinary income. The impact of taxes on savings account can be profound.

I have already shared with you a principal called the “Rule of 72,” which is a way to determine how long it will take for your money to double. Remember: you take the number 72, divide by your interest rate and the number you are left with are the number of years it will take for your money to double. The only problem with that rule is that it does not take into consideration taxes. The “Rule of 72-33-50” shows the impact of taxes. Simply put, because of the lost opportunity cost of taxes, if you are in a combined federal and state tax bracket of 33% it would take 50% longer for your money to double than it would if your money was growing without taxation. If you earned 6% on your savings, your account would double in 12 years if you didn’t have to take money out to pay your taxes. In a 33% tax bracket, it would take 50% longer (a total of 18 years!) for your money to double because of the tax leak in your bucket.

Looking for tax advantaged (ideally tax free) strategies for your savings dollars can make a huge difference over time. If you had \$100,000 in a savings account earning 6% interest over a 30 year period, the account would grow to \$574,349 (assuming that you paid the taxes due each year from your income rather than withdrawing it from your savings). If you were in a 30% tax bracket, you would have paid a total of \$142,305 in taxes over that 30 year period. If your account had been instead growing tax free and that money you paid in taxes had been invested at a 6% rate of return, it would have grown to \$292,593. That is your lost opportunity cost. Now, you could try and make up that \$292,593 cost by being more and more aggressive with your investments (with more and more risk and fewer and fewer nights of sound sleep!) or you could simply plug the leak. Stay tuned in the next chapter for how you can do just that.

The Mutual Fund Tax Trap

Mutual Funds have become tremendously popular over the years and are now by far the investment vehicle used by more Americans than any other. They have their virtues. You can usually open an account with very little to start with, making them an accessible investment for a beginning investor, and they provide immediate diversification, helping you to not have all of your eggs in one basket. I do not mean to suggest that mutual funds never have a role to play but ... well, I just don’t like mutual funds. In the pages that follow I will show you why I feel that way, focusing on 3 concerns: they can be tax inefficient, they can have excessive fees (some hidden, some disclosed) and they often can be chronic financial underachievers. For now, let me touch on the issue of taxes.



Mutual funds invest in a basket of stocks and bonds on behalf of the owners of shares in the fund. The managers of the mutual fund charge a fee (called an expense ratio) to buy and sell the stocks and bonds within the fund when they think it is warranted. The degree to which they buy and sell is called the turnover ratio. John Bogle, the founder of Vanguard and an elder statesman in the mutual fund industry, has said that when he started out in the 1960s, the typical turnover ratio in a mutual fund was around 17%. That means that if the mutual fund owned 100 stocks, they on average bought and sold 17 of them in a given year. Bogle said that today that turnover ratio for actively managed mutual funds averages 85% per year!⁴

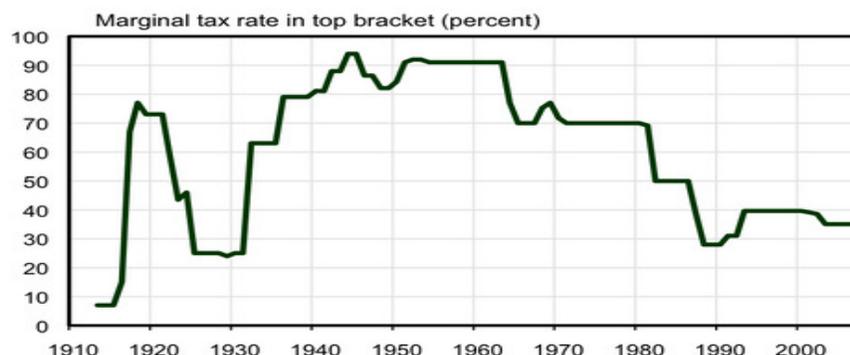
The conventional wisdom used to be that individual investors would, due to the emotional nature of investing, be more prone to be constantly buying and selling while the seasoned institutional investor (such as a mutual fund manager) would be more disciplined. Well, not anymore. Warren Buffett puts it rather comically, “The term ‘institutional investor’ is becoming one of those self-contradictions called an oxymoron, comparable to ‘jumbo shrimp,’ ‘lady mud-wrestler,’ and ‘inexpensive lawyer.’”⁵

What does that mean to you? Well, apart from the added transaction costs that the turnover ratio creates (more on that in a moment), all of that activity can create taxable events for the shareholders of the mutual fund. If you have ever owned a mutual fund you have almost surely had the experience of being notified that you owe taxes from your ownership of the mutual fund shares even though you had not sold a single share of the fund that year. If you own a share of stock, you do not realize a taxable gain until you decide to sell the stock. With a mutual fund, you can realize a taxable gain when the mutual fund manager decides to sell stocks within the fund. It is a matter of who is in control (and let me give you a hint ... it’s not you).

Where insult turns into downright injury is when you end up getting a tax bill for your mutual fund in a year where the mutual fund lost money. These “phantom gains” have vexed investors for years. Your fund may have been down in value by 25% last year but unbeknownst to you the mutual fund manager decided that last year was the right time to sell some stock that the fund had bought years before and that had enjoyed considerable gains during the year. You may not have sold a share of the fund all year, you may be reeling from the emotional shock of seeing a 25% loss on your statement, you may have only bought the fund last year and didn’t even enjoy the benefit of the gain of the stock that was sold ... but you still have to pay taxes. And as we have seen, every tax dollar that you pay also have a lost opportunity cost of what the money could have earned had it been invested rather than having been shipped off to Washington with your tax return.

The 401k Tax Trap

It is hard to believe that there has ever been a time when there was no income tax, but the federal income tax actually was not created until 1913. Since then, the percentage of our income the government takes has been all over the map. Take a look at what the history of the top tax rate has been since the inception of the income tax:

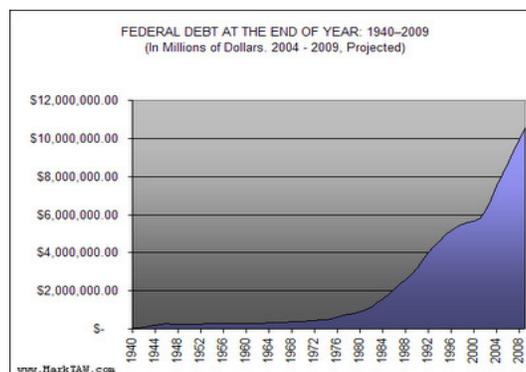


The top marginal tax bracket peaked at 90% during the Great Depression under FDR. President Kennedy lowered the top bracket to 70% in 1960, with Ronald Reagan lowering it again in 1988 all the way down to 28%. The top bracket grew to 39% under President Clinton, fell again to 35% under President Bush and is due to rise again under President Obama. The average of the top tax bracket since 1913 is in excess of 60%.

The question we need to ask ourselves, is where do we think taxes are going to go in the future. Although all of us feel that we are currently overtaxed, the truth of matter is the taxes today are significantly lower than what they historically have been. And then there is government spending ...

I joked with someone recently that I would say our government was spending money like a drunken sailor on shore leave, but I would not want to insult drunken sailors. We are running a tab right now, but sooner or later someone is going to have to pay the bill. Any doubt who that will be? That's right. You and me. The taxpayers.

When you look at the trend lines of the debt our country is accruing, it is not a comforting picture that we see:



When you combine the fact that taxes are historically at a low point with the unsettling reality that runaway government deficits are at an all-time high, it is not difficult to see that the gravitational pull of tax rates is very, very likely to be upward in the future.

What does this mean for you? For many Americans, the number one tool they are using to accumulate money for the future is a 401(k). The money that they put into the plan each year comes off the top of their income, creating a tax deduction. Typically, the first 3 to 5% of what you put into the plan is matched by your employer, which is great. What also seems great but creates huge future tax liabilities is the fact that as the money grows over the years inside the plan it does so without being taxed. When eventually you retire, Uncle Sam steps forward and begins to claim his share. Suddenly, the tax time bomb that has been ticking for years explodes during your retirement years. With tax rates likely to be higher in the future, the damage could be considerable.

A quick example. If you put \$15,000 per year into a 401k and you were in a 30% tax bracket, you would realize a tax break of \$4500 each year. If you did this for 30 years from the time you were 35 until you retired at age 65, you would receive a total of \$135,000 in tax deductions. With a 6% assumed rate of return, the 401k that you put the 15 grand a year into would have grown to \$1,257,025 by the time you retired. Remember now, none of the money has been taxed year. Uncle Sam has been patiently waiting, but he is about to come knocking on your door.

Having let the account grow for 30 years, let's now assume that you want the money in the 401(k) to begin providing for you in retirement, so you structure the account to pay you an income for 30 years, from age 65 to age 95. Assuming a 6% rate of return, that would generate for you an annual income of \$86,152, with the account having a zero balance at the end of the 30 years. In a 30% tax bracket, you would pay \$25,845 in taxes per year, with the total tax bill after 30 years being \$775,368. If taxes were to go up to 50% by the time you retire, the total tax bill over your 30 year retirement would be \$1,292,280.

Let that sink in a moment. To achieve \$135,000 in deductions, you end up paying between \$775,368 and \$1,292,280 in taxes. A tax deferred is not a tax avoided.



Let me ask you something. If you were a farmer, and you had the choice of paying tax on the seed or paying tax on the crop, which would you choose? Obviously, the least expensive alternative would be to pay tax on the seed ... and this principle holds true whether you are a farmer or investor saving for retirement. Tax deductions on the purchase of the seed can feel great at the time, but not so great when it comes time to pay the tax man at when the harvest comes.

One of the foundational principles of SWAN investing is to seek predictability over uncertainty whenever possible. Many 401k savers are banking on tax rates being the same or lower when they retire as they are now. I hope they are right (I hate paying taxes!) but I fear that they have lit a ticking tax time bomb inside of their 401(k) that may very well blow up when they reach retirement age and need to start withdrawing money ... money that will not last nearly as long or go nearly as far if Uncle Sam is taking a much bigger share. For those who want to lock in today's tax rates and not worry about what they may be in the future, one alternative is to invest in your 401k only up to the point where your company matches your contribution (that's just too good of a deal to pass up) and then take the difference that you had been putting in the 401(k) and reallocate those dollars to financial vehicles where withdrawals for retirement are tax free (more on that in the next chapter).

Financial matters that are beyond our control can cause tremendous worry and stress, and even a casual glance at the history of taxes shows how beyond our control tax rates can be. Bringing greater financial predictability when it comes to the enormous lost opportunity cost of taxes can be one way to help yourself sleep well at night as you look to your financial future.

GWIB Leak #2: Wall Street

We have previously discussed in chapter two the subject of risk and how market losses can significantly destroy wealth. Let's turn our attention now to the cost of doing business with Wall Street, and how those fees and commissions can be a significant leak in our financial bucket.

In 1885, William R. Travers, prominent New York businessman and builder of Saratoga Race Track, was taken out for lunch by a Wall Street broker anxious to impress him and win his business. The broker took Travers to a nearby marina to show off his yacht and those of the other brokers who worked for his firm. The businessman looked down the line of beautiful craft and asked, "Where are the clients' yachts?" A good question in 1885, and a good question today.

Stories abound of Wall Street brokerage firms reaping huge rewards even during times when their clients are drowning in a sea of red ink. The pressures for stock brokers to generate fees and commissions for their firms can seemingly be greater than the pressure to create lasting wealth for their clients. Business Week magazine in a cover story entitled, "Can You Trust Your Broker?,"⁶ detailed the incentives that are given to brokers to generate commissions to their brokerage house, how brokers are often not rewarded for client success stories but for company success stories. In other words, "Where are the clients' yachts?"

To look at just one example of excessive, wealth eroding costs from Wall Street, let's examine for a few moments the costs of mutual funds. We have already seen how the tax inefficiency of mutual funds can erode wealth. We now turn our attention to the fees, some disclosed and some hidden, that can be very leaky holes in your financial bucket.



There are a number of potential fees in your mutual fund. Some mutual funds have upfront sales loads of up to 5% ... money that comes off the top of your investment the day you buy the mutual fund. Others have 12b1 fees ... a fee that is charged to you for the advertising expense of going out and finding new investors for the fund. (Imagine if you went to buy a new TV and as you were checking out, the store tacked on an extra \$100 to help them pay for the advertising they had to use to get you in the store ... you might not buy that TV after all!). All mutual funds have a fee called an expense ratio that is the charge (disclosed in the prospectus) for them to manage the fund. Most funds also have transaction costs (not disclosed in the prospectus) that are the cost they have of buying and selling securities inside of the mutual fund. These costs are passed on to you by way of lower annual rates of return.

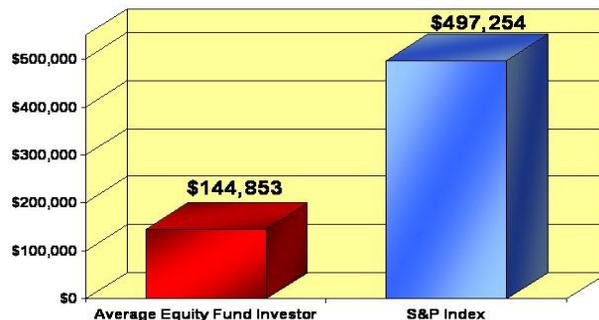
The Wall Street Journal in an article entitled, "The Hidden Costs of Mutual Funds," estimated that the average U.S. stock mutual fund has an expense ratio of 1.31% per year, and that the hidden transaction costs average 1.44% per year. Add them together and you have an annual

cost of ownership of 2.75% per year on average.⁷ One of the reasons that the vast majority of mutual funds underperform the market every year is because they are like the racehorse with the 320 pound jockey ... weighted down by fees, they just can't compete.

We talked earlier about the tax costs of mutual funds. When you combine those tax costs with the costs of fees, the impact can be profound. Another Wall Street Journal article, this one from 2002 gives an example of how this can be: "Effects of taxes and sales charges make some impressive results far less alluring for investors. The \$7 Billion Van Kampen Comstock Fund looks like a strong performer over the past decade, returning an average of 14.5% a year. But its return is far less impressive, at just 9%, once taxes and its sales charge are considered."⁸ That represents a 38% reduction in the return of the fund due to taxes and fees!

Consider the lost opportunity cost of a 38% reduction in the rate of return. If you invested \$50,000 into a mutual fund and it had a gross return of 8% per year, you would have \$503,132 after 30 years. If because of fees and taxes, there was a reduction of 38% in the rate of return, you would only have \$216,097 after 30 years ... a difference of \$287,035!

And what is it that you receive for the fees that you pay? Well, often not a whole heck of a lot. Dalbar, a respected research firm, did a study looking at what equity investors actually earned in the years from 1990 through 2009. So often we are told what the markets have done, but it is important to consider first and foremost what our money has actually done for us. The Dalbar study found that the S&P 500 Index was up an average of 8.20% during that time period, while the average equity fund investor only earned on average 3.17%.⁹ The chart below shows the difference this would have made on a \$100,000 investment:



Due to poor investment decisions by the Wall Street experts who are advising investors, fees and commissions paid on investments and bad decisions made due to the emotional turmoil of the markets that cause us to buy when we should sell and sell when we should buy, investors significantly underperformed the markets. Losses hurt us not only in the short term when our account statements come in the mail, but also in the long run with the lost opportunity cost of what those losses would have gained for us over the years had they remained in our accounts and kept on working for us.

GWIB Leak #3: Insurance Companies

We have an odd relationship with insurance companies, do we not? Perhaps the only things we buy in our lives that we hope to never get any use from is an insurance policy. We buy homeowners insurance hoping we never have a fire, health insurance hoping we never get sick, auto insurance hoping we never have an accident and life insurance hoping we will never die. (At least with the first 3 types of insurance that I just listed you have a shot at never having a claim ... not so much with the last one).

The fact that we have a necessary relationship with insurance companies does not mean that we have an obligation to overpay for the insurance policies that we carry. Often an adjustment in the terms of your coverage to be more appropriate to your needs can lower your costs without jeopardizing your financial security. Those recaptured premium dollars can then be put to work to provide for your financial future.

The purpose of insurance is to protect us from economic hardship, not to protect us from never having any out of pocket costs. We are going to talk in the next chapter about establishing your own “bank,” an account that you create to give you tax efficient access to money when you need it. By raising deductibles on insurance slightly, the reduction in premium can often more than compensate for slightly higher out of pocket costs. Often the reduction in premium is equal to 2 years of the increase in deductible. In other words, as long as you don’t have a claim every 2 years (we’re talking about some *really* bad luck here!), you could come out ahead. Let’s look at a few hypothetical examples from the perspective of a married couple who we will call Bob and Jane Swan:

Home Owners Insurance. Let’s assume that you have a home worth \$200,000. If your deductible is \$250 and you increased it to \$1000, you could potentially lower your premium from \$1000 a year to \$500 a year. If that \$500 per year were invested over a 30 year period at a 6% rate of return, it would be worth \$41,901 for Bob and Jane.

Auto Insurance. Same idea here. If you have a car worth \$30,000 and your premium for a \$250 deductible was \$2000 per year, an increase in your deductible to \$1000 could lower your premium to perhaps as little as \$1200 per year. This \$800 annual savings invested at 6% over a 30 year period would grow to \$67,041, more money to create a more comfortable retirement.

Health Insurance. This decision will rest to a great degree on the particulars of your health situation, but if you were comfortable raising your deductible here, the savings can be tremendous. If your deductible was \$250 and your annual premium was \$9000, an increase in your deductible to \$1000 could decrease your premium to perhaps as little as \$6000. This \$3000 annual savings, invested for 30 years at a 6% rate of return, would grow to \$251,405 ... that additional \$251,405 recaptured without increased market risk could go a long way towards Bob and Jane Swan increasing their retirement lifestyle while decreasing their level of financial stress.

Life Insurance. Many people today buy term insurance for their life insurance needs and when they do it is almost always for the same reason: it is cheap. Term life insurance, because it is not guaranteed for the rest of your life, is a much less expensive alternative than permanent life insurance. A big part of the reason (and this is where insurance companies can really make out well) is that according to study conducted by Penn State University, more than 97% of all term life insurance policies never pay a death claim!¹⁰ Why? Because the policies are sold, typically when people are younger, for a specific period of time that statistically not many people will die during.

It is sort of like the difference between renting and buying a home. Renting a home can be a fine idea while you are moving towards home ownership, but is not a sound long term financial decision (unless you are the landlord!). When I look back at the money I paid to rent a home when I was younger, I wince at that money that was solving a short term need of putting a roof over my head but was not building long term equity. Life insurance can be like that as well. A permanent life insurance policy can provide not only a future legacy for your loved ones, but can also build cash value at competitive rates of return on a tax favored basis for you. (More on this in the next chapter).

To rent your life insurance by buying term has an opportunity cost that goes beyond the premiums. If Bob Swan, as a 35 year old in good health, purchased a \$1 million term policy for 30 years with an average annual premium of \$2000, he would have spent \$60,000 in total premiums over 30 years. Had those dollars been invested and earned a rate of return of 6% over 30 years, he would have had \$167,604. That, however, is only part of the lost opportunity cost because if the policy does in fact never pay out the death benefit, there is a \$1 million lost opportunity cost to his family who will never receive those proceeds!

Let's now add up the recaptured insurance lost opportunity costs in this hypothetical scenario for Bob and Jane Swan:

Homeowners Insurance: \$41,901

Auto Insurance: \$67,041

Health Insurance: \$251,405

Life Insurance: \$167,604

That comes to a total of \$527,951 of recaptured lost opportunity costs ... some big leaks in the financial bucket, plugged. This is now money that Bob and Jane could utilize for a more comfortable retirement and a greater legacy ... all without additional risk or stress.



GWIB Leak #4: Banks

The last wealth destroyer of the four headed GWIB that we are doing battle with is the Banks. One of the foundational principals of finance is that money that is at rest tends to stay at rest and money that is in motion tends to stay in

motion. We have much to learn from banks about putting this principal at work for ourselves. Consider the way that banks make money. It all begins when you walk into the bank and make a deposit into your savings account. The bank then pays you 2 or 3 percent and takes your money and loans it out to someone with a credit card, who pays the bank back at an 18% interest rate. With that money, the bank is able get a second turn on your money when they loan out those dollars to someone else who wants to buy a car and pays the bank 10%. The third turn on your money is when the money paid back from the auto loan is lent out to a business that wants to expand and takes out a business loan, paying the bank an 8% interest rate. The bank then has a fourth turn of your money when they loan out the money to a young couple who takes out a 30 year home mortgage with a 6% interest rate. And on and on it goes.

Remarkably, the person making the savings deposit to give the bank working capital is often the same person who is borrowing money from the bank to pay it far more in interest than it is paying you! It is a great deal for the bank and a really, really lousy deal for you. The costs of finance over the course of our lifetimes is enormous and a major reason why most Americans never come close to their full wealth potential.

In the next chapter, we will look at a life changing strategy of creating your own financial entity to serve as your bank where you can have the benefit of the velocity of money that your bank has long enjoyed, but before we pursue a solution, let's look more closely at the problem through a few examples of the destructive power and lost opportunity costs of debt.

Credit Cards. If from the age of 35 until the age of 65 you were to carry a credit card balance of \$10,000 at an interest rate of 18%, you would over the years pay a total of \$59,149 in interest. Had those dollars been invested each year at an average rate of return of 6%, you would have had an additional \$165,226 in your pocket at age 65.

Auto Loans. Let's suppose you financed a car for \$30,000 every 5 years from the time you were 25 until you were 75. Your payments would be \$579.88 per month, and every 5 years you would have paid the bank \$4799 in interest. Over a 50 year period you would pay a total of \$47,990 interest, but the real cost is your lost opportunity cost. If you had invested the money you paid in interest at a rate of return of 6%, you would have generated an additional \$330,773 of wealth over the course of your lifetime!

Home Mortgage. This is where the number gets uncomfortably large. If you took out a 30 year mortgage with a 6% interest rate for \$250,000, you would pay more in interest over 30 years than the home was worth when you bought it ... a total of \$289,595. If that money that you paid in interest had instead been invested and paying you an interest rate of 6%, you would have an additional \$1,505,644 of wealth at age 65! We often refer to our houses as "home sweet home." We pay the bank dearly for that sweet tooth.

In the examples above, the lost opportunity cost of finance over our lifetimes for credit cards, auto loans and a home mortgage would be a total of \$2,001,643. These leaks in your financial bucket need to be plugged, and you can do so as you will soon see by becoming your own

“bank,” paying interest to yourself instead of a financial institution and recapturing those dollars that have been flowing to your bank. More on that in the next chapter.

Chapter Summary

One of the foundational SWAN principles of financial planning is that there is far more money to be made by plugging leaks in our financial buckets than there is in frantically trying to pour more and more money into our buckets with more and more aggressive levels of risk. If we can recapture the enormous lost opportunity costs that have been leaking into the coffers of the government, Wall Street, the insurance companies and the banks, we can build significantly more wealth at significantly lower risk. All while sleeping well at night.

¹ E. Mansfield, Economics: Principles, Problems and Decisions. 1977.

² www.taxfoundation.org

³ www.ivdgl.com

⁴ John Bogle, Common Sense on Mutual Funds, 2004. Page 25.

⁵ Bogle. Ibid. Page 27.

⁶ Business Week, Can You Trust Your Broker. 1/27/1997.

⁷ Wall Street Journal, The Hidden Costs of Mutual Funds. March 1, 2010.

⁸ Wall Street Journal, Mutual Fund Returns Are Different Amid New Rules. April 12, 2002.

⁹ Dalbar Research, “Quantitative Analysis of Investor Behavior.” Dalbar.com

¹⁰ Anthony Steuer, Questions and Answers About Life Insurance. Page 34.

Please note that all hypothetical rates of return cited are for illustrative purposes only and not reflective of any specific savings or investment product. Estimates regarding fees, insurance costs, bank interest rates and taxes are hypothetical and these will vary based upon individual circumstances. Tax rates are subject to change. Past performance is no guarantee of future results. Investing involves risk, including the loss of principal.