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Winter 2016 Newsletter:

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Investment Ideas Packaged in Bling...These Are a Few of My Least Favorite Things

With apologies to Rodgers and Hammerstein, we would like to turn our attention to any investment vehicle whose hype and style overwhelms its substance. The simple question to ask is, why bother? Some years ago, we came to the conclusion that 90%+ (OK, this is only our subjective estimate) of all financial products are marketing gimmicks.

Does this mean that we are calling them "bad" or "scams"? Not in the least. But the sobering truth is that if you know about or could be advised on a high quality, low cost, plain vanilla product with essentially a best-in-class rating (or at least consistently found on a medal winner's podium), why bother with something else? Just because a commission based product salesperson (CBPS) pushes it, or a financial services company hawks it as their "me-too" competitor (when what they are really doing is trying to play catch up), or even when the government gets in on the game by creating yet another type of retirement account (and in the process merely confuses the very people it is trying to serve)?

Here is just a small sample that we will explore in more detail:

1. Mutual funds with sales loads (front, back, or level, it doesn't matter)
2. Insurance based products (such as indexed annuities) marketed as investments
3. The new MyRA retirement savings account

Load Based Funds

Way back in the 20th century, before online account access to the major mutual fund complexes and stock brokerages existed, the typical approach was for a CBPS to sell investment company shares (i.e. a mutual fund) to investors and to be compensated in the form of a commission, which was and still is called a sales load. Mutual fund companies wanted to focus on managing, not marketing, their funds. The rationale was clear and logical, although not very cost effective for the consumer.

With the rise of the Web, access and marketing have been made cost effective. Still, some companies felt the need to spend millions of dollars on TV advertising that basically says one thing: "Ask your advisor about XYZ". Guess what? XYZ is the last thing we would recommend to our clients, if for no other reason than they are wasting current shareholder money (if a 12b-1 fee is being charged to all shareholders, in order to get the next shareholder through the door).

By contrast, top companies can target their audiences in a more laser like fashion, by advertising on financial Web sites and placing Ads in industry journals and perhaps

consumer oriented magazines, such as Money and Kiplinger's. Additionally, if XYZ is so good, your adviser should already know about it, right?

Following a strict fiduciary standard, an investment vehicle should never be recommended by an adviser simply because it will result in more (or even any) compensation to the adviser. This is not a sufficient reason.

Removing load funds from the equation serves to remove this temptation, as long as the remaining no-load investment products can match the former in all other respects. While this may not have been the case decades ago, we would challenge anyone to demonstrate why load funds should be the basis for any investor's portfolio in this day and age.

While Vanguard has been one of, if not the preeminent leader, in low cost, no-load mutual funds, Fidelity and T. Rowe Price have also done commendably in this area. But please note that these latter two and some other fund companies still maintain “advisor” share classes of funds that charge noticeably higher expenses, in order to compensate CBPSs along the way. These fees do not go toward buying you greater fund management expertise, as an investor. They are simply directed toward marketing and distribution. Please keep in mind that the lower the overall cost, the better the resulting performance of the comparable no-load share class.

While it may sound somewhat ironic, we have never recommended an “advisor” share class of a fund to a client of our own investment advisory practice. Why not? Because a pure no load alternative has always been found, or the client already had access to the fund in question through their employer's qualified plan (in this case, without ever paying the sales load!).

Insurance Products as Investments

This is not meant as a diatribe against insurance, which is a critical financial product. Our only argument is when insurance products get dressed up in “bling”, in order to promote them as investment alternatives.

When we use the term “bling” here, it is meant to highlight something used as a distraction or when style is valued over substance.

The nature of insurance as pure protection, is where we think it is of most value. Plain vanilla solutions can be very effective and cheap as well. But when the CBPS essentially equates it to an investment, or makes it seem superior to investments, then we cringe.

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When an insurance product (not explicitly stated to be a variable product or regulated as a variable product), is called an investment or is compared to an investment, we believe this to be flat out wrong.

No real investment that we know of is truly guaranteed. Investments have risk and this is natural. An investment without risk is like a zebra without stripes. Perhaps they exist, but we have never seen or heard of one. While absence of evidence is not evidence of absence, we choose not to be obsessed dwelling on the exception. Even "insured" municipal bonds carry multiple risks.

Investing is inherently risky. But risk is meant to be managed, not merely avoided altogether.

So a cash value whole life insurance policy, fixed deferred annuity, or one of the complex present day "indexed annuities", are really forms of savings. They are not investments. Ask the CBPS selling them, "Are you an investment adviser? Has this product been registered with the SEC? Or is it really just an insurance contract?".

Rest assured, we still like savings vehicles. But it is important to keep the following in mind:

1. How much do they cost to operate? It may not be easy to find out the whole truth.
2. What access do you have to your money after you purchase it (i.e. liquidity)?
3. What is the surrender charge, if you need to withdraw from the product? How does this charge decline over time?
4. What is the amount and percentage of commission that the CBPS will receive upon selling it to you? You probably are not paying this commission directly, the product seller is. But the more they pay the CBPS, usually means that the less that is left for you, the policy holder or annuitant.
5. Higher commissions also mean more incentive to push certain products. What explanation does the CBPS give that his product is in your best interest?
6. How does cash value accrue to the insurance product? Typically, the parameters for this are established in the insurance contract itself.

The last point needs amplification. Just because something is stated in the contract, the insurance company may retain the right to change the formula determining how much it will pay the policy holder as a return, especially for indexed annuity products. This is critical. We liken it to the concept that the insurance company will ultimately pay you what they feel like paying you, as long as it agrees with the complex language of the contract.

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So who is taking the risk now? The CBPS and insurance company maintain that they will not lose your principal, but so long as you do not maintain much access to it. But if there is no predefined rate of return and the guarantee is only for the original value of the account and not its inflation adjusted value over time, this guarantee loses much of its luster.

Furthermore, current radio and TV commercials tout things such as “reasonable rate of return”, “paycheck for life”, “retain your gains”, or “advanced annuity strategies”. Look more closely at the fine print and you may need a magnifying glass. What are they trying to hide?

Many of these statements are subjective in nature, imprecise, or lack connection to any ascertainable standard. So what exactly is the definition of “reasonable rate of return”?

Finally, new contracts can be revisions to older ones, dropping more consumer generous features, while increasing expenses. Understanding how your new insurance product will accrue value over time may not be readily comparable with a previous product, if the contract terms are sufficiently different.

What to do? Ask lots of questions. Look for more low cost, plain vanilla product alternatives. Even consider different approaches, such as charitable gift annuities (for those retirees who may already have a charitable leaning, along with a desire for lifetime income). But treat these for what they are: forms of savings and not investments.

MyRA: Just Say “No” to Some New Ideas

What if they built a new type of retirement account and no one came?

After a plethora of different retirement account types had been developed over the last several decades, one would think that there already is a retirement account available to fit virtually anyone's requirements, budget and risk tolerance. But I suppose not.

Along comes the U.S Treasury with the ***MyRA*** (My Retirement Account), in November of 2015. This account can be opened with as little as $1 and has no fees or special requirements, other than having earned income to cover the contribution (just like an IRA)[1]. The “bling” here is the over emphasis on safety. No one will ever lose any of their principal. However, like everything else, this feature comes at a price. There really is no true investing going on. There are no investment choices. The sole asset class is a US Treasury securities fund, which in 2014, earned just a 2.3% return. This has prompted personal finance writer Gail Marks Jarvis to comment that “people who depend on that level of safety during a lifetime of saving will probably discover that safe isn't safe in the long run”[2].

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The federal government is pushing its MyRA idea as a way for low to moderate income people who have no retirement account, to begin saving, with the expectation that they will eventually roll it over into a Roth IRA. According to the rules, the maximum accumulation in this account is limited to only $15,000[3].

Here is our take on MyRAs. Good intentions can result in those who need help actually becoming worse off, due to the confusion of focusing on the "bling" of supposed safety and no account minimums.

While many people have retirement investments through employer based qualified plans, such as 401(k)s, some employers do not provide any such plan. But any employee with earned income can still open some type of individual retirement account (IRA). The issue could be that many low income people simply do not have the disposable income to reach the minimum account level required. Fair enough.

But look at what message the MyRA actually sends:

1. *Just start putting a few dollars away*. But if the savers using this strategy are otherwise finding ways of spending $100-$200 or more monthly on "wired and wireless" plans, etc., then thinking that retirement deserves less in the way of attention or funding is uninformed, at best.
2. *Nothing to worry about, since your principal is safe*. But what about later on? If people get used to positive returns every single year when they have such small amounts of money, how will they feel when they experience their first calendar year loss with a much larger sum, later on? Instead, if they "lost on paper" 20% of a $1,000 balance, this would be an unrealized loss of $200, or perhaps just two months worth of "wired and wireless". <u>This initial emphasis on safety of principal defeats the purpose of investing, of learning about investing and of gaining experience and confidence in investing</u>.
3. *There are no investment choices*. Eventually the saver will be confronted with many choices after they roll over their account into a Roth IRA, leading to potential confusion.
4. *We got your back, since there are NO fees*. While the account has zero fees, we will discuss below how an actual investment portfolio can have fees so low, that this point is actually irrelevant.

What alternative would we recommend instead? <u>A low or moderate income person would probably be better served by using a Roth IRA</u>, instead of a traditional one, since the current year income tax deduction of a traditional IRA would be of little value to someone who does not have much, if any, present income tax liability.

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What about account minimums? Well, there are a few target date funds from mutual fund companies that can be purchased with as little as $1,000. For example, while The Vanguard Group requires a minimum $3,000 investment in one of its regular funds, the actual minimum on a Target Date Fund is only $1,000[4]. This is an important point to make, since a target date fund is an all-in-one investment portfolio for a small investor who is just starting out. It has a shifting asset allocation and re-balances itself automatically.

In terms of fees, the Vanguard Target Retirement 2060 Fund (ticker symbol: VTTSX) (meant for those retiring around 2058-2062) has a 0.18% expense ratio, with no sales loads, redemption charges or 12b-1 fees. This means just $1.80 of expenses per $1,000 invested. To think that zero expenses for a MyRA, which would not even pass a simple test of being a diversified investment portfolio, is a better choice than $1.80 in expenses for the same $1,000 contribution? Enough said.

Could we do even better for a low or moderate income person who is also an income tax payer? Yes, we can. It's called the Saver's Credit and is a tax credit for those of lower incomes who contribute to a retirement account. The amount of the credit is 50%, 20% or 10% of the contribution, up to $2,000 ($4,000 if married filing jointly), depending on adjusted gross income (AGI). For 2015, the 50% credit required an AGI of not more than $36,500[5]. This tax credit has a low income threshold, indeed. However, its purpose is to help many of the same kinds of folks being targeted for the new MyRA.

So what could a low income couple do? Perhaps scrimp and save in a bank checking or savings account first. Come up with the $1,000 minimum required for the Vanguard Target Date Fund (there are many of them, not just for young people), get their income tax return prepared and then voila! They may get up to a $500 tax credit that could minimize or eliminate their income tax liability. This effectively decreases the amount of money required for opening the account, assuming the person can count on getting money back in the form of a tax refund. Perhaps the same person can adjust their tax withholding down during the year, in anticipation of the credit, thereby accumulating the funds needed to open the account, faster.

Assuming the account is a Roth IRA, contribution limits would still apply. But for the low income participant, subsequent contributions can be made with as little as $1. This can be transferred via ACH debit from a linked checking or savings account.

Now this is real investing. Hold the “bling”, please.

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The Doctor Will See You Now and Do Bring Along Your Health Savings Account

When we talk about there being seven "meta-asset classes": ***Investments***, ***Savings***, ***Job/Business Skills***, ***Life Skills***, the ***Ability to Manage Money***, ***Health*** and ***Time***, it may seem that we have gathered a motley crew. Surely, these are separate and completely disparate things. Some are more tangible than others. Why would we even bother grouping them this way? Well, consider the somewhat surprising definition of *motley crew*: "a group of people of mixed background, especially one with a common goal"[6] (our emphasis added).

The ***Castling*** principle is based upon the notion that strength is achieved through difference and diversity, simultaneously using two fundamentally different things.

Consider the old saying, "if you've got your health, you've got everything". Perhaps this is not completely true, but most everyone would acknowledge that their health can impact their personal finances and that their financial situation can impact their health.

While we cannot guarantee that our health will always be robust, it is generally accepted that lifestyle factors such as diet and exercise, preventative medical screenings, adherence to a doctor's prescribed schedule for taking medications, etc. are all helpful in maintaining or enhancing the level of health we may currently enjoy.

While the Affordable Care Act has been nothing, if not controversial, the basic idea of a population being covered under some form of health insurance seems reasonable enough. Our criticism stems from observing a lack of free market incentives on the part of patients, health care providers and insurers.

Every patient is ultimately a consumer. Four key questions that every consumer is constantly asking, regardless of whether they realize them or not:

1. What do I want?
2. What do I need?
3. What can I afford?
4. What am I willing to pay for?

Whether buying an ice cream cone from a street vendor, a new car from a local dealer using the latest smart phone app, or scheduling non-emergency medical treatment, these questions will still be evaluated.

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While few people would sacrifice the quality of their health care in a life and death decision, for most of the time, some compromises are found to be acceptable. For instance, most health insurance plans pay only for a semi-private room in a hospital. This does not seem to cause much consternation, even though the risk of infection is higher in a room occupied by two patients, instead of just one. The extra money to pay for the private room would need to come out of the patient's own pocket. What would they likely do? Probably forgo what is otherwise a higher quality choice, because semi-private is considered acceptable.

Our view is that people free to choose, in free markets, make better choices in almost every situation. We can scarcely think of the exceptions. If central planning was so successful, the Soviet Union would still be around, wouldn't it?

And so it should also be with health care. The insurance principle is built around the idea that a relatively small, certain loss (the premium) is better than an unlikely, but potentially catastrophic, large loss. Without getting lost in a history lesson, this did not happen with health insurance. The situation instead morphed into a Hodge-podge of somewhat absurd expectations. We call it absurd in the sense that “insurance” is mixed with a “service plan” or “warranty”.

We once again, in order to gain some understanding in an area that appears foreign or complex, to instead take a comparable situation from a more familiar area, lift it out of its context and place it into the context of the former.

For example, suppose I need maintenance on my automobile. Will I file a claim with my auto insurer? Probably not. Does this mean I would cancel my car insurance in disgust? No, since the policy is protecting me from far worse perils, should they happen. We take it as a given that car repair and maintenance will mostly (though not always) be covered out of our own pockets. We therefore make choices regarding how long we will own our cars, whether we buy or lease the next one and especially, we consider the four questions above. Does anyone doubt this happens on a daily basis?

Well, we admit that the health care and health insurance areas are not exactly the same as the auto example just discussed. But this dates back to WWII imposed wage and price controls that “promoted” employer based insurance, the rise of government intervention in health care, the regulation of the insurance industry at mostly a state level, the peculiar income tax status of both insurance premiums and benefits for both employer plans versus individuals, etc. So no truly free market exists. A “hot mess” would be a better descriptor.

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So when the Health Savings Account (HSA) was invented, was it meant to correct all these issues we have raised? No, not at all. However, it is a very commendable attempt at restoring some measure of freedom of choice into our health care lives. Freedom has both rights and responsibilities. We need to fulfill the latter to enjoy the former, otherwise we end up burdening others.

Here we cover the general features of health savings accounts, the role they play in our access to health care, as well as some important concepts and tips that are not widely discussed.

First, the basics. A health savings account (HSA) is meant to be a companion to a high-deductible health plan (HDHP). It is used to accept tax deductible contributions that in the current or future years, can be used to pay for qualifying health care expenses, free of tax. Whatever contributions are not consumed in the current year, can be invested for growth with all earnings being income tax deferred. To be eligible to open and make contributions to an HSA, you must be covered by a qualified HDHP, not be enrolled in Medicare, not be enrolled in a plan other than the HDHP and not be claimed as a dependent by another taxpayer. Since there are additional details we cannot hope to cover here, we encourage you to use ***J.K. Lasser's Your Income Tax*** as a very handy reference[7]. While there have been entire books written on HSAs, some of the best are now relatively dated. Using one very low cost tax guide each year such as this one, along with Websites of providers of HSAs, will usually suffice.

When we say that the HDHP must be "qualified", we mean that certain limits apply and they could vary each year. So "high deductible" is not a subjective term here. For 2015 and 2016, the minimum deductible is $1,300/$2,600 for self-only and family coverage, respectively. Maximum out-of-pocket costs for 2015 were $6,450/$12,900 (self-only/family coverage), increasing in 2016 to $6,550/$13,100[8].

It is important to keep in mind that out-of-pocket costs do not include the insurance premiums. Additionally, the minimum annual deductible does not apply to preventive care benefits, a qualified list of which is provided by the IRS.

However, prescription drug benefits must be subject to the HDHP minimum annual deductible. This latter constraint is perhaps the single biggest obstacle preventing some people from using the HDHP/HSA combination. If a person is taking a number of moderately expensive "maintenance" medications to treat chronic conditions, it may not be worthwhile to spend thousands on deductibles, each and every year.

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The conventional wisdom is that an HDHP/HSA is best for healthy people. There is some truth to this, but shouldn't a financially aware, healthy person: a) try to maintain their health and b) take advantage of lower cost options?

By contrast, a person who needs a sizable level of health care for one or a few years may find that the quality of coverage under an HDHP is just as good as under a conventional (low deductible) plan. Once the deductible is satisfied, expenses are usually covered at the same or higher level, meaning the coinsurance percentage you pay should not be any more and may actually be less than, another plan. Of course, you must read your policy, plan document or benefits guide to know for sure.

An HSA has contribution limits. For 2015, this was $3,350/$6,650 (self-only coverage/family coverage). In 2016, the applicable contribution limits are $3,350/$6,750. For those age 55 or older by the end of the year, an extra “catch-up”contribution of $1,000 may be made[9].

If the HDHP is employer based, the employer will oftentimes contribute to the individual's HSA account. This counts against the contribution limits previously stated.

The best way to take a distribution from an HSA is to pay for qualified medical expenses of the account owner, or his or her spouse or dependents. This type of distribution is tax free. Considering that the contribution was pre-tax and earnings were tax deferred, this should sound like a great deal. Unlike a flexible spending account (FSA), the contributions do not have to be “used up” by the end of the calendar year, otherwise known as the “use it or lose it” phenomenon.

Take a distribution for any other reason and it will be taxed as ordinary income. In addition, unless the account owner has reached age 65, become disabled or has died, there is also an onerous 20% penalty tax[10]. However, treated properly, there should be no reason to take distributions for other than health care expenses. Worried that your health might be too perfect, causing you to take non-qualified distributions? Then simply wait until age 65. Or perhaps find a different problem to worry about.

Now here are some important points that may not be obvious from simply knowing the basics.

1. Having earned income is not a requirement in order to contribute to an HSA, as it is for an IRA. For example, an early retiree who is not yet eligible for Medicare and is covered by a qualifying HDHP, would have the opportunity to accumulate a significant amount of health savings in the years leading up to Medicare.

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2. HSAs are portable and do not depend upon maintaining the same employer plan or any employer plan, as long as it is still a qualifying HDHP. For example, a terminated employee who finds it more advantageous to be covered on a spouse's HDHP, could still continue to own and contribute to his old HSA.
3. A Medicare enrollee who already has an HSA can still keep it, even though additional contributions would not be permitted. This is useful for both the relatively young and healthy person who focuses on accumulating savings for use as a senior, as well as the much older person who has only a few years to accumulate, until Medicare kicks in at age 65. For the latter, even the ten years of "catch-up" contributions possible from age 55 to 65, will provide at least an additional $10,000 of savings.
4. A one-time transfer from an existing IRA to an HSA is permitted. This transfer is income tax and penalty free, but the maximum amount is the annual contribution limit of the HSA and also counts toward that limit[11]. Our point is that this is yet another method to accumulate health account funds in a shorter period of time, assuming you already have an IRA.
5. The HSA is superior to using the medical expense exception for IRAs. In the latter, you take an IRA distribution, but the 10% premature withdrawal (pre-age 59 ½) penalty does not apply to the amount equal to medical expenses above the 10% of AGI floor (7½ % of AGI if you or your spouse is 65 or older). In other words, instead of using IRA funds in a far limited way, the HSA will cover more.
6. Contributions are free from federal and state income tax, but also free of FICA tax (Social Security and Medicare). This is not the case with IRA or 401(k) contributions, by contrast. So even someone in the low 15% marginal income tax bracket can wind up with 25%+ tax savings, factoring everything in.
7. Many banks and financial services companies offering health savings accounts actually split the one account into two parts. The first is a "demand" account which is accompanied by a debit card (that can be run through the credit card networks), as well as a checkbook. Nominal interest may or may not be credited to the balance in this part of the account. The second is an "investment" account that can be held for growth and further income, by investing in one or more mutual funds. There may be a minimum balance requirement in the demand account, such as $1,500, before deposits can be made into the investment account. This assures that there are funds available to pay for the day-to-day expenses for which the account was originally created.
8. The ability to invest is well known. What is less well known is the fact that certain asset classes make more sense in HSAs, compared to others. For example, REITs (real estate investment trusts) or REIT funds/ETFs pay higher dividends as a group, due to their unique tax structure. But these dividends are not qualified from an IRS point of view, resulting in taxation as ordinary income. But throw a

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REIT fund into an HSA and now you have the capability of turning ordinary income tax treatment into completely tax free income and gains!

9. Finally, consider the impact on consumer behavior. Some folks will avoid going to the doctor, doing wellness checks, etc., simply because of what these infrequent, but normal expenses, do to their monthly budgets. The HSA actually helps to modify this somewhat self-destructive behavior. How? Because once a decent balance has built up in the account, the consumer can make the doctor's visit or get that test done. If and when a $1,000 bill shows up that would disrupt their budget, they will be able to handle it with the demand side of their account. The HSA is simply a different pot of money from their regular checking account. In terms of their monthly budget and spending plan, all they see is a known, predetermined amount each pay period going toward the HSA contribution. In this case, it would not be a $1,000 bill that blows a hole in their budget. The HSA acts as the true "rainy day" fund, allowing them to seek out the care that they need. But it still encourages them to be naturally careful with funds that, if not truly needed for care today, would continue to grow and be used for their future.

If the HSA qualified HDHP is ultimately what helps a person get covered by health insurance, due to its comparatively lower premiums, so much the better. By having some form of coverage, this person will be protected from catastrophic scenarios, as well as receive "provider adjustments". These are discounts from the full retail price that they would likely have been stuck with, had they remained uninsured. The use of pre-tax money to pay for needed care is essentially another "discount".

The future of health care, in our opinion, should be more free market based. It should incorporate consumer opinions and desires along the lines of the basic questions we asked at the outset. The patient needs to spend some of the first dollars. This will lead them automatically to ask more and better questions that should result in spending their own money more wisely than governments or insurance companies would. They would also demand more answers. This will lead providers to respond. Patients have been passive in their health care decisions and its financing, for far too long. The health savings account, while not any kind of panacea, is a most welcome innovation.

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More Than a Dozen Different Ways of Investing in Real Estate...None of Which Involve Your Home

Since the conventional wisdom is so prevalent and yet so wrong on the following point, we need to emphasize repeatedly that your primary residence is not and never has been, an "investment". An investment is really the placement of capital in a profit seeking enterprise of some sort. This could be the stock of a publicly traded company, a rental property, the debt of a corporation, a mutual fund or ETF, precious metals, even US Treasury notes and bonds. In the latter case, the Treasury department may not be the one seeking to make a profit, but since the market value of even their own securities go up and down, their buyers are looking to make an ultimate profit on the combination of both interest income as well as eventual capital gain (or potential loss) upon sale.

The resulting possibilities of both losses, as well as gains, demonstrates the inherent risk that is associated with investing. But another characteristic is that we do not derive general "economic utility" from them, while we hold them.

(OK, let's cut the gobbledygook, you may be thinking, as you consider putting this down and going back to something more useful, such as defrosting the refrigerator.)

What if I told you I was going to "invest" in a new wardrobe? But it's for my business, of course. What would my new look be without a new sports car? But I'm just "investing" in myself, right? A $250 haircut every month? How about a manicure to go with it? More "investing"! At this rate of "investment", I may be in the poor house before most everyone gets to see my new look.

The serious point is that money spent on something that does not have a real return and that would otherwise be viewed as pure consumption is, well, just consumption.

A primary residence serves the primary purpose of putting a roof over our heads. This is an economic benefit we derive, apart from any potential gain upon its eventual sale. Saying we are "investing" in a kitchen remodel for a home we are planning to occupy for the next thirty years, is a misnomer. This is pure consumption since components deteriorate. Appliances break down. Kitchen decorating trends change. By the time the home is sold, the kitchen may well be a negative selling point, because it may need to be updated once again.

By contrast, remodeling the kitchen of a home purchased for rehab and resale is an investment. We are not stating that this is good or bad. But if we will not be using this kitchen, the whole point is whether the potential buyer likes the remodel.

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The characteristics making this an investment is the potential gain upon the sale of the property, or the rental income received if we decide to hold onto it. The same holds true with any financial asset. We may receive interest from a corporate bond, dividends from our stocks and a capital gain from an ETF. But the corporation did not feed, clothe or house us (though perhaps we received a glossy report and invitation to their annual meeting).

Since a primary residence is not an investment, but still is an asset, it would be useful to categorize it. So using our ***Castling Principle***, we have stated previously that home equity is part of a ***Savings Portfolio***. For someone planning for, or already in retirement, this is an important distinction. If the expected time horizon to remain in the home is very long or indefinite, then the market value blips, whether happening day by day or even year over year, are almost entirely irrelevant.

At this point, if we have been even moderately successful in convincing you that your primary residence is not an investment, we have accomplished our first objective. Our other goal is to introduce more than a dozen different ways of investing in real estate, both directly and indirectly.

While this is not meant to be an exhaustive list, it does cover a lot of ground in a short period of time. The investments shown exhibit various risk and return characteristics. This does not make one of them necessarily best or worst (although we have our opinions). It does make them different and that is a good thing from the standpoint of diversification. We also describe a way to invest in them that you may not have considered, along with examples where appropriate.

1. A REIT (real estate investment trust) is a company engaged in the real estate business and set up as a tax pass through entity. This means that they do not pay income taxes, but instead, must pass through at least 90% of their net income to shareholders, in the form of dividends. But in exchange for this benefit, these dividends are not considered “qualified” for income tax purposes and are taxed as ordinary income. Most REITs invest in commercial real estate and own and operate office buildings, shopping malls or apartment complexes that are leased to tenants[12]. Simon Property Group, Inc. (ticker symbol: SPG) is the largest and perhaps best known REIT.
2. A REIT mutual fund provides the diversification of having the shares of many individual REITs in one pool that can be combined with other mutual funds that comprise the bulk of most investors' portfolios. The Vanguard REIT Index Fund (ticker symbol: VGSIX) is a low cost and high quality alternative. However, there are also very good actively managed funds in this area. Fidelity® Real Estate Investment Portfolio (ticker symbol: FRESX) has a long and successful track

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record. A great way to own a REIT fund is actually in a health savings account (HSA), since qualified distributions will be completely tax free.

3. A REIT ETF (exchange traded fund) provides the same benefits as a REIT mutual fund, but is bought and sold on a stock exchange, using a brokerage account. This means that transactions can be made during the trading day, unlike mutual funds which are only valued once per day after the market has closed. The benefit of having active pricing comes at the cost of having to pay standard brokerage commissions in order to make each trade. The Vanguard REIT Index Fund (ticker symbol: VNQ) is essentially equivalent to its mutual fund counterpart. The tip here is that you can trade many ETFs for free, by having a brokerage account with the participating fund family. For example, VNQ is commission free to those investors with a Vanguard Brokerage Services account.
4. International REIT exposure is available through mutual funds that focus on this subset. Due to increased volatility in investing outside the US, we currently do not recommend investing outside of a mutual fund (or ETF), in this area. Once again, Vanguard has a low cost offering in this space: Global ex-U.S. Real Estate Index Fund (ticker symbol: VGXRX) and an ETF (VNQI).
5. A less diversified and more concentrated form of REIT investing is to focus on individual sectors that are unique business models outside the mainstream we have already mentioned. For example, ***American Tower*** (ticker symbol: AMT) is a leading independent owner, operator and developer of communications real estate, with a portfolio of over 99,000 communication sites, worldwide[13]. Another unique business is data centers. In this space, ***Digital Realty Trust, Inc.*** (ticker symbol: DLR) is prominent[14]. The point we are making here is that for an investor interested in a particular type of business, there may be a real estate component to that business. If so, it will naturally achieve growth parallel to the core business line.
6. How about owning a "slice" of many rental properties, without directly owning any of them? ***American Homes 4 Rent®*** (ticker symbol: AMH) is a REIT that acquires, renovates and then leases single-family homes as rental properties. As of September 30, 2015, they owned over 38,000 single-family properties across 22 states[15]. Since they are currently reporting a loss and the stock price has been at the lower end of its range over the past several years, this may indicate that the business model of rental properties on a very large scale, may be difficult to be profitable. However, this type of business model is far different from those previously mentioned. If rents in the single family home market move upward over the next few years and their costs are well contained, this business may turn around. We would be cautious about making a large investment in it, however.
7. <u>Active participation rental real estate is the old standby</u>. The term means that the owner(s) are involved in the rental activity, but this does not necessarily mean that they are real estate professionals. Expenses associated with the rental, including

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maintenance, repair, property taxes and HOA fees can be deducted against the rental income. The physical property can be depreciated for income tax purposes. Rental income can be used to pay for the financing costs of the property (the mortgage) or can provide useful income to the owner, especially heading into or in the early stages of retirement. The owner is usually the landlord, unless he or she retains local property management that agrees to provide all of the services. Since financing a rental property is not the cheapest way to get a mortgage, one method is to use equity from or refinance a primary residence, to provide funds to pay for the rental. Lenders make loans on a primary residence at lower rates. Of course, care must be exercised here. This is valuable reason to get a primary residence paid off, before buying a rental. Overall debt is then minimized.

8. A variation on the previous rental real estate idea has been highlighted by the popular HGTV program: ***Vacation House for Free***[16]. In this case, a fixer-upper is purchased in the owner's desired vacation paradise. Financing is likely a necessity. Rehabbing takes place and this does not always assume that the owners are available or able to do the work. The end result is a vacation home that fits their exact requirements. By renting it out during whatever the peak season may be in their locale, rental income is maximized, which can then be allocated toward paying operating expenses and financing costs. The trick is to get enough rental income that would balance off all expenses. At that point, the owners are able to enjoy the vacation home “for free”. We tend to like this idea, as long as the house purchased is found to be structurally sound and there is very good local property management or relatives/friends who will be participating in the activity. The expenses of management could add up and this is an area that needs to be further researched in every case. The price of real estate varies tremendously, hence the old saying “location, location, location”. But costs of materials vary by far less and the costs of appliances by perhaps very little. Labor costs tend to vary by region. All told, the same project may be a relative bargain in one location and an expensive mistake in another. But this basic idea has merit.
9. Flip this house? Next to rental real estate, fixing and flipping homes is another mainstream investment technique. While many bargains in foreclosed houses were available in the years following the financial crisis and recession, fewer and fewer such properties are seemingly being located, with each passing year. Not only is financing or having enough cash available the most critical factor, most lenders do not really want to finance small scale construction/remodel projects. From our past experience and everything we have learned on the subject, the next most important factor after having the financing is a realistic budget. Over improving a house in a neighborhood that cannot sustain a high asking price is an investment killer. Working with a reputable contractor experienced in the kind of project you are looking to do is only half the battle. He needs to know project management and overall cost estimation, to create a realistic budget. This needs

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to be determined before physical work begins, resulting in a cost range (minimum to maximum). A competitive market analysis (CMA) by a realtor should provide a range for likely sales prices. The third part of the upfront analysis should include all acquisition and carrying costs (i.e. keeping the lights on and paying the taxes), likely cycle time from closing (on the purchase) to closing (on the eventual sale) and some expected rate of return. Plugging in the purchase price, max cost estimate, min sale price and likely carrying costs over a longer time frame will result in a more pessimistic, but cautious rate of return. If it looks bad on paper, you may have saved yourself from a costly mistake by avoiding the project altogether. One of our favorite tools in this area is Zillow[17].

10. A variation on the fix and flip rehab scenario is where the investor does not add any sweat equity and is, in fact, prohibited from doing so. This would be the case with a self-directed IRA (SDIRA) investing in buying, fixing and then reselling houses. Explaining an SDIRA truly requires more time and space than we can devote to it here. Basically, a different type of custodian is involved, who holds title to or merely acts as record keeper for, the real estate transactions. The properties are either purchased with the SDIRA being the owner, or by a legal entity such as an LLC, owned by the SDIRA. The IRA owner is prohibited from contributing money or labor directly to the project. Everything must come through the SDIRA. While this structure is very limiting, it is quite a diversifier from the other real estate ideas we have discussed. It is also quite different from simply owning financial assets. This is clearly not for everyone, since the amount of assets necessary in the SDIRA in the first place, would be an amount necessary to buy the property. The only permitted type of financing is called "non-recourse". However, partnering with a "non-prohibited" (i.e. unrelated) person is acceptable. One of the leading SDIRA custodians is The Entrust Group[18].
11. A Tax Lien Certificate is not real estate, but it is linked to real estate. Local taxing jurisdictions such as counties, assess the value of parcels of real estate and then tax each property, according to their own formulas involving tax rates for every local taxing authority, such as school districts, park districts, libraries and so on. If a property owner fails to pay the taxes owed within a certain period of time (typically set by state law), the county has the right to "sell the taxes" to investors, thus helping to maintain their revenues. Evidence of this is called the tax lien certificate. Investors hope to earn the penalty interest rate that the delinquent owners will ultimately need to pay. If not paid, the properties could eventually be sold at a tax deed sale. This interesting area is unfortunately fraught with some local legal complexities. The assistance of an attorney experienced with tax liens is highly recommended.
12. Buying raw or semi-improved land with no intention of building on it. This method of real estate investing is truly speculative. The idea would be to invest in a location that could one day become a hot residential or commercial area. The

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land could then be subdivided into smaller lots and be resold for a handsome profit. In theory, this is much easier than in practice. The ability to have the "inside" information required is questionable, if not illegal. Otherwise, it is nothing more than a guess. Still, some people are convinced that land is a great investment because unlike widgets, nobody's making any more of it. We would recommend staying away from this one.

13. Private Mortgage Notes, while not a direct investment in real estate, are certainly backed by real estate. We had a lot to say about them in a previous Newsletter. Private mortgage notes form the basis for a truly customized transaction, not unlike a complex financial product, except that the complexities can be features that help you and not just cost you money, as with a commercial product. We do not recommend going out and finding someone to sell you a non-performing note. What we are saying is that people we already know, especially family members and friends, could be buying properties. We can go out and see them for ourselves. However, they may have difficulty getting conventional mortgages, due to the lack of money for the down payment. Private mortgages come to the rescue by having the lender set their own terms, which could include a much shorter payback period and fixed or variable interest rates that are at least as great as the IRS defined Applicable Federal Rate (AFR). The borrower can build equity much faster than with a traditional mortgage, allowing them to refinance conventionally in a few years. The lender could be a retired family member who depends on the mortgage payments as part of their monthly cash flow. This could make their investment portfolio last longer. Since each mortgage payment contains both interest and principal, the combination could mean that less is needed to be withdrawn from traditional financial assets.

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Applying the Castling Principle to Solve the Student Debt Crisis

The usual format of our essays has been to describe a certain scenario, use it to explain concepts and lay out examples demonstrating these concepts, especially with reference to our ***Castling Principle***. Up to now, these have been current law/fact based. The reader can go out and apply the concepts immediately. Here, we depart somewhat from this formula, by looking at how our principle could, hypothetically, be used to help solve a large scale national problem.

We, therefore, make it clear from the outset that our solution does not currently exist. It would require a basic legal framework to be developed, along with certain protections, to prevent moral hazard. It would need financial services companies to act as the intermediaries (i.e. the "go between"). It would fully utilize both the most recent advances in information technology, as well as various social media platforms.

Variations of this idea have been proposed by others, most notably the late economist Milton Friedman in his famous book, "Capitalism and Freedom"[19]. More recently, Mitch Daniels, president of Purdue University and former governor of Indiana, has described a similar idea, although with some differences from what we are proposing here[20].

However, our specific implementation of this idea, as with the others cited above, will undoubtedly come under attack by, well, let's just call them "fanatics of the status quo". But our intention is definitely not to be political here. This is meant to be a free-market solution to a hugely vexing problem, that does not depend upon the fleecing of the American taxpayer, continuation of moral hazard, wealth redistribution, or enriching institutions of higher learning, most of which pay no taxes but still make huge amounts of money (perhaps labeled as "endowments").

So what is our idea and why do we need such an introduction instead of coming straight to the point? Let's start at the beginning. The real beginning. The foundation of all human interaction, in our judgment, is based on one simple concept. Understand it and you're halfway to success in life. Fail to grasp it and you may always end up struggling. It is this:

Value for Value

But in more contemporary parlance, we may say it this way: "***if you want to get something, you need to give something***".

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The ability of a human being to participate in a transaction, willingly and at arms length, with another person, is the cornerstone of all human endeavor. Something has value not simply because I say it has value, but because I hold it up for you to see and you in turn, agree with this assessment. You agree not because you fear me, want to placate me, appease me or curry favor with me. You agree because you would like to buy that item from me. Trade is mutually beneficial, regardless if I am a pauper and you are a king. True enough, we may haggle over a price and other terms and conditions, but if in the end, we both agree to the transaction without coercion, then something has just occurred that is to our mutual benefit.

If we are competent parties in terms of legal age and mental capacity and the other elements of a valid contract are likewise present, what can be so wrong with this arrangement?

What if that something is not a tangible item, but the value of a college education? What if the parties to the transaction represent the two things we describe in the ***Castling Principle***:

The simultaneous use of two fundamentally different things, in such a way that you achieve a result that could not have been achieved using just the one or the other.

Consider the following characteristics of the average college graduate:

1. This person may have moderate or significant debt in terms of student loans outstanding.
2. This person may or may not have career oriented full time employment lined up.
3. This person has their whole working career ahead of them, is young, strong and full of “life energy”.
4. Compared to someone who did not go to college, this person has a lifetime earnings capacity that has been stated to be over one million dollars more than an uneducated person. While this number may also depend upon many factors, most people do believe that a college education adds significant earning potential.
5. This person has zero current capital (or close to it).
6. This person, without looking at the value of human capital, probably has a negative net worth.

Now let's look at the average investor (it could also be most people in retirement who have an investment portfolio as well as home equity):

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1. This person probably has little or no debt, apart from possible mortgage debt. Compared to the graduate, it looks like little or no debt.
2. This person may already be retired or in the tail end of a career.
3. This person may be middle aged or older, perhaps has seen more robust health and may only consider a second career based upon their interests. "Starting over again?" is not something they would entertain.
4. This person has already made a return on their education and experience.
5. This person has capital to invest. Some of course have more than others. But for every investor, the question is also one of diversification, by holding assets with various risk and reward characteristics.
6. If a retiree, this person may very much be interested in yield. So investments paying interest or dividends, especially regularly, are favored.
7. This person has a positive net worth that represents "what they've got to show for it", the sum total of their previous "life energy" compounded to the present day.

Excuse us, but does anyone else see these two people as being fundamentally different, in terms of where they are on life's long journey? If so, couldn't they come together, in some synergistic fashion, such that the end result is something both can benefit from?

The process may be called an "income sharing arrangement"[21]. It can also be called buying "a share in an individual's earning prospects"[22]. Opponents, especially those who are misguided or worse, call it indentured servitude or slavery.

We call it "Going public as the CEO of ***Me, Inc.***" by offering shares that are the equivalent of preferred stock: a fixed percentage (of income) dividend that has no "voting" rights.

Some see the solution to the student debt crisis to be as simple as changing federal law to allow student loan debt to be discharged in a bankruptcy proceeding. We call this ridiculous and irresponsible, since it encourages moral hazard. Student debt is comprised of not just past tuition and textbooks, but of room and board and other expenses. Some students took out much more debt than others. Some went to more expensive schools. Some took six years to graduate, just to get a four year degree. For everyone who partied hard, there was another one who was hard at work: studying, working part-time, attending a local school, going to a less expensive school. Some of them studied difficult subjects that led to the attainment of marketable skills and ultimately, entry level jobs. Others focused their energies in, let us say, more "nontraditional" pursuits.

Have someone else pay for your education, make a bunch of poor choices, ring up a mountain of debt and then declare: "See, there is no way for me to pay this back. Let's wipe the slate clean. I'm only 22, and need to start living!". If only life was that easy.

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Perhaps not quite, but this may not be that much of an exaggeration for some. The Wall Street Journal has reported how a federal government program, started in 2007, forgives federal student debt after ten years of payments based on a low percentage of income, as long as the person works for government or nonprofit entities. The biggest benefits seem to be going to medical school students who owe close to $200,000 after graduation[23]. The question is whether these graduates really "pay back" the full economic cost of their education, in that ten year time period, through a combination of regular payments and acceptance of their temporary lower salary. It does not appear that this is likely. Once freed from the ten year obligation, the graduate can pursue the highest paying employment attainable, thus leaving the rest of us in their earnings cloud of dust.

Other taxpayers who never see major future salary increases that such advanced education can bring, nevertheless "foot the bill" through a combination of higher taxes, more government debt and lower economic growth.

Our alternative does not depend upon taxpayers picking up the tab, foreigners buying more US Treasury debt, or the Federal Reserve printing more money. The ***value for value*** and ***Castling*** principles provide another way.

Here is a hypothetical illustration based upon a student who has accumulated $50,000 of debt on the way to becoming a graduate. The current interest rate and yield curve environment is assumed. It should be kept in mind that the numbers may be altered significantly if the level of debt, or yields on other investments, are different or change over time.

1. Almost nothing really new happens prior to graduation. The student selects the school, major field of study, financial aid package, determines how to pay for it, how much debt to take on in the form of student loans and all other choices inherent in the higher education process, perhaps some or all of it with significant family involvement. As we will notice later on, incoming students and their families would be able to use data from older graduating classes, to determine which choices provide higher probabilities of success. If anything, the student serious about "going public" would be more mindful to stay clear of bad choices, perhaps live more modestly, endeavor to finish in four years and not make career wrecking postings on social media, among other things.
2. Upon graduation, the student decides whether it would be worthwhile to "go public". This decision is not based upon force or involuntary servitude. The person is free to choose. Going public will necessitate paying one or more investors an annual dividend based upon the graduate's future gross earnings (with a threshold minimum we will discuss below), and the number of shares they have

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purchased. It is expected that this dividend payment would continue for their entire career, which we define here as the lesser of forty years, or until age 65.

3. Whoa! Seem like serfdom, right? Wrong. As we will describe in further detail, the annual dividend would be the greater of 5% of their gross income or $1,500. The minimum amount is equivalent to $125 a month. Compared to what the person is probably spending on cable TV plus wireless plans and lattes, this does not seem onerous. While a gross salary of more than $30,000 will mean a larger dividend, we will describe a simple way in which the successful graduate can eventually "go private" by redeeming the preferred shares, allowing them to stop paying the dividend altogether.
4. The new process begins with the graduate preparing an "offering document" using some predefined template (this could just become a standard contract form), not unlike a prospectus, along with a whole set of presentation materials. This is where using social media will come in handy. The graduate may or may not have already secured career level employment at this point. The important point is to not lie or make material misrepresentations. The graduates should put their best foot forward and demonstrate what they have to offer the world and why investors should be interested in them.
5. Using a newly developed marketplace, financial intermediaries may offer their services of matching the graduates to one or more investors. The investors bid on purchasing shares of the new IPOs of various graduates. As with any investment portfolio, diversification is very important.
6. The key point at this stage is that investors would be willing to *bid down* an internal rate of return value that defines what it would take to eventually redeem the preferred shares and "go private". This would be based upon multiple criteria: the attractiveness of each graduate's actual or potential future income, current or future employment, soundness of decisions made up to this point in their lives, as well as their ability to put together a convincing and professional presentation.
7. For example, a nominal rate of return could be set at 5-7%. Popular graduates may be able to get investors to bid this down to 3-5%. Investors are always free to choose whether to bid lower or not, depending upon their risk tolerance and appetite for potential return upon redemption. A lot depends upon the yields available on other investment vehicles, once we adjust for risk.
8. The graduates would be required to submit enough information to the financial intermediaries, to satisfy reporting requirements as to income. Their annual dividend payments must also be sent in. There would be a need to verify income data later on, via the IRS. When Milton Friedman first wrote about this more than fifty years ago, the information technology to make reporting requirements feasible and cheap enough, did not exist. This is no longer the case. Government's role in this idea is not to provide funding, but to make sure accurate disclosures are being made, while safeguarding the personal identity data of the graduates.

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9. Graduates have a natural incentive to better their lives by earning more money. So there is alignment in the goals between them and their investors. Disrespecting investors is the fastest way to destroy the entire idea. This is where strong legal safeguards for the investor, actually help the entire class of graduates do better in the long run, by holding down the cost. <u>If moral hazard was allowed and certain graduates were able to shirk their responsibility to pay their annual dividend, investors would naturally try to make up the deficit, by demanding a higher expected return from the others who do pay</u>.
10. The immediate benefit of this idea for a graduate, is that the annual dividend to be paid (the greater of 5% of gross income or $1,500, based upon investors having paid off an initial $50,000 debt) is extremely affordable as compared to making fixed loan payments upon graduation. <u>Since the size of the dividend to pay depends directly upon the income level, the graduate would still able to create a budget and allocate their income to things like car payments, rent, saving for a down payment on a home, etc</u>. In other words, the graduate does not need to put his or her life on hold for the next decade or two, or necessarily work for a government or “government approved” entity, in order to accumulate “loan forgiveness credits” that are ultimately paid for with taxpayer dollars (or fresh debt).
11. The graduate actually and legally would have their debt paid off and thus, removed from their net worth statement. The obligation to pay the dividend would still need to noted/disclosed on any loan application. But <u>the nature of the dividend would make it easier for them to get future financing to buy autos and homes, as compared to carrying student loan debt</u>. Let's keep in mind that deferred student loan debt continues to accumulate interest, which is then added back to principal. By having investors pay this off at once, right after graduation, the amount can be minimized.
12. In comparing this idea to preferred stock dividends, we would like to emphasize the safer nature of the dividend as compared to common stock dividends (i.e. investors need basic protections or else you kill the goose that laid the golden egg), as well as the the concept of “no voting rights”. In other words, <u>no one would have the right to force the graduate to change jobs in order to boost income, or to prevent a graduate from taking time off to have a family or take care of a family member</u>. The minimum dividend amount (i.e. $1,500) would, nonetheless, still be required to be paid.
13. <u>Some graduates will go through their entire career with substandard earnings</u>, as compared to others. <u>As a result, their investors may see, after inflation, a negative return. This is simply a risk that comes with investing</u>. Since the investors freely accepted this risk, as long as no fraud was committed by the graduates or the financial intermediaries, we do not see any problem.

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14. We recognize that many investors may not want to collect dividends from a graduate for the next forty years. The answer to this question is a secondary market that provides liquidity to the initial investor who wants out. The shares are then re-sold to some other investor. Market values could go up and down, depending on the anticipated present value of the cash flow stream. Since there is a fixed date when the preferred dividend stream dries up on its own, at the end of the graduate's career (the lesser of forty years or at age 65), the value of these shares in the secondary market will gradually shrink on their own.
15. What about the moderately or highly successful graduate? We can define "success" in two phases. In the first, the sought after graduate sees their rate of return value bid lower during the IPO process as investors seek out who they think is the "cream of the crop". Years later, the graduate has been promoted one or more times and has received a number of salary increases. Perhaps they have also been rewarded with stock options or a restricted stock grant. So what if they feel they are on the cusp of "hitting it big"? Paying $5,000 (5% of a $100,000 gross income) and up, year after year, may get to be tiresome (although it would still be feasible). The way out would be for the graduate to "go private" by redeeming the shares outstanding. Once redeemed, the graduate would no longer make any payments to an investor. Best of all, the graduate is in complete control as to if and when they would want to do this. Investors would have no legal recourse to prevent it.
16. Does anyone think the investors will sit around complaining: "Why that rotten kid! Now that he's struck it rich, he goes private and stiffs me out of all his future income". Not at all. In fact, investors would welcome such an occurrence. Here is how it would work. The graduate with the newly found wealth/income, would pay the investor a lump sum equivalent to the amount that equates the internal rate of return of ALL the cash flows, to the percentage agreed upon at the time of IPO. It may be worthwhile for the graduate to even borrow money to do this. The investor, having realized the exact rate of return on his investment that he had expected, now has his capital returned to him. He is free to once again reenter the market and search for a new graduate and start the process over again, or to look for a different investment entirely.
17. Nothing is "free" when it comes to the expenses of running this type of market. We do expect financial intermediaries to charge the investor community an operating expense ratio. It remains to be seen how much this would be and to what extent would economies of scale be realized. In addition, the financial services companies would add a very useful service by taking out life and disability insurance policies on the graduates, up to the amount of the capital contributions of their investors. Tragedies can happen, but this coverage would be very inexpensive for at least the first two decades after graduation. Once again, investor protections lead to more investor participation, which means more and

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cheaper capital, which is ultimately in the best interests of graduates. Value for value!

18. We have already covered the scenarios where the graduate has either a very successful career or a mediocre one. In both instances, investors were initially attracted. But what if no investor wants to buy any shares from a particular graduate? In our opinion, this is clear evidence that the college or university that conferred the degree upon him or her, did them no favor. We think that the Federal Government should demand of this institution that they personally absorb from 10-25% of that graduate's student debt, as a penalty for a sloppy job poorly done. Why? They are in control of awarding degrees. If the graduate is not quite up to par to attract investors, what does that say about the educational institution? If they refuse to cooperate, perhaps all future federally backed student loans to this school should be held up. That would get their attention. This may sound somewhat cynical on our part, but the endless loop of passing out ever larger credit cards to students and their families, just so colleges and universities (whether for profit or not) can jack up tuition and fees, has got to stop somewhere.
19. Here is a side benefit of this IPO idea, which really does not exist in the present environment. Investors (and the financial services companies supporting them) can and should perform due diligence before investing. The end result of this will be some very useful databases regarding what works and what does not work, as far as graduates are concerned. What schools had the most successful graduates? What majors did they select? What was the appropriate amount of debt and what was excessive? Was living modestly and endeavoring to finish in four years rewarded by investors or ignored? We would like to stress that what should be of utmost importance to the incoming freshman and his or her family, should not be an obsession with school or major, but with the whole picture as it will appear after graduation. This means the sum total of all the decisions made. As a student, your life is not "made" just because you were accepted to the school of your choice. By contrast, going public will not be the best solution for some graduates. But simply having it as another potential choice to compare to, is valuable. If it leads a few to find less expensive alternatives that avoid most or all of the debt that present day students are taking on, so much the better.

Finally, let's look at an example. This graduate has $50,000 of student debt being eliminated by the investors. The 5% dividend rule stated above is in effect. The following table shows some hypothetical earnings. Note how the income level is quite low at the outset, prompting the default dividend payment to be made. Slowly, her income level rises, first due to standard increases and then due to promotions. As with many liberal arts graduates who enter the business world, this person does get significant promotions and earned an advanced degree along the way, this time paid for by her current employer. Ultimately, this person changed jobs again during year 15, causing full

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year earnings to skyrocket up to $100,000. At that point, seeing that the dividend payment was going to increase to $5,000, she made a decision to use some of her stock options, savings and even a 401(k) loan to “buy out” the investors and go private. The cost of this decision was $44,000, the amount that made the whole cash flow stream produce an internal rate of return of 4.47%. This was the value initially agreed to by investors, who bid down the original rate, due to the attractiveness of this candidate. Keep in mind this was 15 years later, so the time value of money was much less, but the human capital value was much more.

If we can all agree that higher education is essential to success in the modern world, but that nothing in this world is “free” and everything works on the ***value for value*** concept, there should be a place for this free-market based solution to the student debt crisis.

Student Loan Amount:	$50,000			
Dividend Percentage:	5%			
Min. Dividend Payment:	$1,500			
Dividends First Paid:	After one year, which allows graduate to file a Federal Income Tax return.			
Dividends Paid Thereafter:	Annually			
Internal Rate of Return:	4.47%			
Shares Redeemed:	After 15 years when graduate has become successful.			
Year #	**Age of Graduate**	**Gross Earnings**	**Dividend Paid**	**Lump Sum**
0	22	$15,000	$0	
1	23	$30,000	$1,500	
2	24	$32,000	$1,500	
3	25	$35,000	$1,600	
4	26	$40,000	$1,750	
5	27	$43,000	$2,000	
6	28	$50,000	$2,150	
7	29	$53,000	$2,500	
8	30	$57,000	$2,650	
9	31	$62,000	$2,850	
10	32	$66,000	$3,100	
11	33	$70,000	$3,300	
12	34	$75,000	$3,500	
13	35	$80,000	$3,750	
14	36	$85,000	$4,000	
15	37	$100,000	$4,250	$44,000

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References

1. MyRA account information can be accessed via the Treasury Direct Website using the following link:
https://myra.gov/

2. Marks Jarvis, Gail, "New MyRA a safe investment – maybe too safe", **The Chicago Tribune**, November 7, 2015. This article can also be accessed via the following link:
http://www.chicagotribune.com/business/columnists/ct-marksjarvis-myra-1108-biz-20151106-column.html

3. Why Choose MyRA? information can be accessed via the Treasury Direct Website using the following link:
https://myra.gov/why-choose-myra/

4. Information about Vanguard funds was obtained from their Financial Advisor's Website. For personal investors, **The Vanguard Group** has an excellent Website and information about target date funds can be accessed via the following link:
https://investor.vanguard.com/mutual-funds/target-retirement/#/mini/fees/1691

5. Retirement Savings Contributions Credit (Saver's Credit) information can be accessed via IRS Website using the following link:
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6. "Motley crew", definition from **Wiktionary**. This definition can be accessed via the following link:
https://en.wiktionary.org/wiki/motley_crew

7. J.K. Lasser's Your Income Tax 2016, John Wiley & Sons, Inc., pp. 54-56, 211, 685-686. This is an extremely useful reference which costs so little that it is affordable to buy every year. The next step up would need be a "textbook" costing well more than $100. This book can be reviewed and ordered on Amazon using the following link:
http://www.amazon.com/J-K-Lassers-Your-Income-2016/dp/1119133920/ref=sr_1_1?s=books&ie=UTF8&qid=1449109528&sr=1-1&keywords=j.k.+lasser%27s+your+income+tax+2016

8. Ibid., p.55.

9. Ibid.

10. Ibid., p.686.

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11. Ibid., p.56.

12. The **National Association of Real Estate Investment Trusts (NAREIT)**, is the main industry trade group. Their Website includes very useful videos explaining the functioning of REITs, as well as a wealth of other information and data. It can be accessed via the following link:
https://www.reit.com/

13. The **American Tower** Website can be accessed via the following link:
http://www.americantower.com/corporateus/investor-relations/index.htm

14. The **Digital Realty Trust, Inc.** Website can be accessed via the following link:
http://investor.digitalrealty.com/investor-relations/general-investor-overview/investor-relations-overview/default.aspx

15. The **American Homes 4 Rent®** Website can be accessed via the following link:
https://www.americanhomes4rent.com/

16. The **HGTV** Website and the ***Vacation House for Free*** program information can be accessed via the following link:
http://www.hgtv.com/shows/vacation-house-for-free

17. The **Zillow** Website contains a wealth of individual property data, estimates of value, tax information and ratings of school districts. It has truly revolutionized the way we look at real estate. It can be accessed via the following link:
http://www.zillow.com/

18. The Entrust Group Website can be accessed via the following link:
http://www.theentrustgroup.com/

19. Friedman, Milton, **Capitalism and Freedom**, The University of Chicago Press, 1962 (fortieth anniversary edition, 2002, cited here), pp. 100-107. This book can be reviewed and purchased online through many booksellers, including Amazon, via the following link:
http://www.amazon.com/Capitalism-Freedom-Anniversary-Milton-Friedman/dp/0226264211/ref=sr_1_1?s=books&ie=UTF8&qid=1449372524&sr=1-1&keywords=capitalism+and+freedom

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https://www.washingtonpost.com/opinions/a-different-solution-to-student-debt/2015/08/20/d2e140b8-37bb-11e5-9d0f-7865a67390ee_story.html

21. Ibid.

22. Friedman, p. 103.

23. Mitchell, Josh, "Costs Mount for Student Program", **The Wall Street Journal**, November 21-22, 2015, p. A3.

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