MIKE CHADWICK'S

MONEY MATTERS

ADVISING, EDUCATING & INSPIRING YOU TO A BETTER LIFE

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What Level Are You?

People love rankings, statistics, numbers, lists, etc. We've decided to boil the whole financial world down to various levels of individual participation. We all love to be number one, but very few of us have the motivation and work ethic to work hard enough to prepare to be number one in our given discipline. There are studies that indicate once you've spend 10,000 hours doing a particular activity, you'll become expert at it, or at least as good as you'll ever become at it. When it comes to money and finances we've boiled the system down to levels of participation and depending on where you put your money, what level you're participating in the financial system.

Money ends up in the same place regardless of where you put it, it ends up at the basic levels of the financial system after the middlemen are done doing their thing with it. This explanation helps clarify and demystify how the financial world works. With a clear understanding of how the system works, you'll be able to make more informed decision about where you'd like to keep your money and at what level you'd prefer to participate in the financial system. The base level for money is level 1, that is where the rubber meets the road and that is the closest level of participation you can have in the financial world today. Level 1 is the trading floor (or computer screen) of various exchanges. When you're watching the evening news and they talk about the stock market and in the background you see the papers flying and the people running all over the exchange, this is level 1. As we move away from that baseline, the levels grow higher and your money is further removed from the basic level of the financial system, moving through the hands of more middlemen (the financial

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Inside This Issue

Predatory Lending

Nobody wants to deal with the real issues in the world today, they are placated by just attacking ancillary parts of the problems. Mortgage brokers, Wall Street, corporate greed and financial deregulation have all come under extreme scrutiny in recent years as being all bad, evil beings following last years meltdown. Just like any other industry, there are dirtbags and good, honest people in these industries. It's unfair to classify them all as bad, even though there are plenty of bad ones and plenty of bad people in any industry – financial advisors, car salesmen, lawyers, etc. The real predators in lending are the dim bulbs in Washington.

Look at the evolution of mortgage requirements coming out of Washington. In the 1970's they created The Community Reinvestment Act to help low income families buy homes. That's great and it all works well for 20 years while it followed prudent lending standards. In the 90's Clinton expands it dramatically to include more and more people, regardless of their ability to pay for a home and throwing financial prudence to the curb, also creating subprime mortgages and mandating what banks must do, forcing them to lend to those that are at or below 80% of the median income. This changes the playing field and even conservative banks must have a certain percentage of loans in this market to continue to have access to the discount window. This is where it all started to unravel. Up to this point, real estate appreciated along with inflation, at about 3% on the surface. If you factor in ownership costs, etc. you lose money but that's for another day. From the updating of this act to the 2007 peak, real estate appreciated at almost a double digit clip. Clearly an unsustainable appreciation rate, but the peak of the real estate bubble that the policymakers innocently created almost 15 years ago in disregarding financial facts.

Now the geniuses in Washington are trying to force new rules on the financial industry to "stop abusive practices." That's all great, but lending is now so conservative, arguable more conservative than it needs to be, but on the back of last years meltdown understandably so. Any new rules will have very little to no impact on underwriting decisions financial firms make, they'll just add cost and minutia to the businesses participating in such areas

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world calls them intermediaries), getting charged more fee's, etc. at each level and getting further and further away from where the rubber meets the road. Along this journey, things get complicated, sexy and more sophisticated. Each level adds a layer of benefits, costs and complexity.

Let's use oil and an oil well as an example of my rating system. If you're the owner of the oil well you own the oil that comes out of the ground so you're a level one participant. What you do with the oil is now up to you. If you had the refining capacity you could then make your gasoline, diesel, etc. with said oil and burn it in your home, car, lawnmower or chainsaw. Assuming you don't own the well, as most of us don't, if you own the trucking company or pipeline you'd be participant # 2 delivering the oil to the refinery, the next person in line to get their hands on the oil. If you owned the refinery, you'd then be participant # 3. If you owned the next trucking company or pipeline to get it from refinery to distribution, you'd be participant #4. If you owned the shipping company with barges, you'd be participant # 5 transporting the oil to the destination nation and market. If you owned the oil storage tanks you'd be participant # 6, storing it at port for the next stage. If you owned the next distribution channel, you'd be participant # 7, you'd buy in bulk and wait for local dealers. If you owned the gas station or oil company, you'd be participant # 8. As the homeowner or car owner, you're participant # 9. There are 9 people who "touch" your oil from pumping it out of the ground to pumping it into your oil tank or gas tank. The government taxes oil at every step of the way as a side note. How they don't have enough money is beyond every logical ounce of my being! ☹

Back to money, it's not quite as simple as a barrel of oil but here we go. If you don't trade the underlying investment securities directly on a trading floor or electronic exchange you're not a direct participant. You can buy all sorts of things on the trading floors or exchange systems in our world, vehicles such as stocks, bonds, options, commodities, currencies, etc. There are also vehicles that don't have a regulated exchange such as credit default swaps that the government is working furiously on to create one. Anything else that is not directly traded is at least one level removed. This is level 1 of the financial system.

Level 2 participants in the financial world would be buyers of mutual funds, hedge funds, exchange traded funds, closed end funds, unit investment trusts (UIT's) – these tools all own various underlying securities, but you're buying them after someone else has decided what to buy, bought them, packaged them, charged a fee to do it, and then sold them to you. These vehicles are mostly liquid and also trade on exchanges, but not at their most basic level, they're one level up the totem pole.

Funds of funds are level 3 participants, this is where you buy a mutual fund, ETF, UIT or other instrument where they in turn buy other funds, which in turn own the actual underlying securities. Welcome to level 3.

Annuity buyers are level 4 participants. Similar to level 3, but the insurance company has now added life insurance and some guarantees to the funds or contracts and you now have more perks, more complexity, and more systemic cost of what you now own.

Insurance companies are highly complicated corporations, their foundation is typically made of mostly bonds and real estate held both directly and indirectly through various level 2 & 3 instruments such as mortgage backed securities (sexy level 2 or 3 bond tool) as well as common and preferred stocks owned at the levels 1, 2 & 3 levels. When you buy an insurance product that is guaranteed by the general fund of the insurer, you're now at the tail end of whatever the insurance companies net operating profit or loss does for the particular book of business backing the vehicle you purchased. When you put your money in an insurance company, it doesn't sit at the headquarters, it's immediately deployed in their investment division likely buying level 1 investments. Insurance companies have very sophisticated trading desks and are specialists in bonds and fixed income assets. I'd call insurance company products other than annuities level 5 assets.

Banks are similarly complicated to life insurers. A banks core assets are it's loan portfolio and securities portfolio, which mostly consists of bonds, real estate and real estate backed instruments such as mortgage backed securities, mortgage funds, etc. The bank will offer you savings, cd's or money market instruments as a way to gather capital at a low cost, then turn around and invest that money in whatever they choose at a higher rate. The bank is arguably the best business in the world, they use your money, pay you very little to do it by offering you a guarantee, invest it and keep the spread. Their investment could be a car loan, mortgage, credit card loan, student loan, bond, stock or whatever they choose. They try to gather assets for as little as possible and earn as much as possible on those very assets once they get them, this is the "spread" and it's how the bank makes money. Well run banks will have a 3-10% spread between the cost of money and their return on assets. When you put your money in the bank it isn't sitting in the vault, it's being invested immediately by a division of the bank. Banks also have very sophisticated trading operations, specializing in real estate, bonds and mortgage backed securities. Bigger banks have trading desks with the complete ability of an investment firm. Banks know how the money works, that is why they have buildings made out of stone, brick, marble or granite. People typically don't know how the money works and they often live in homes made out of particleboard or aluminum. ☺ If you keep your money in a bank you're a level 5 participant in the financial system.

If you have a pension from a government or other employer, that money is pooled and often parted out to many investment firms, with the treasurer or pension committee responsible for the prudent management of the plan. At the end of the day, that pension money is in the same place as all of the other money, in level 1 investments controlled by someone else, but through a litany of middlemen. Pensions, endowments and the like would be level 6 participants in the financial system. What level are you participating at in our financial system? What level would you like to be participating at? ☺

Noteworthy News! ! !

- Congratulations to Jeff Mickiewicz on the purchase of his new home! ☺
- Congratulations to David & Tracy Reid on their recent marriage, the beginning of a beautiful life together! ☺
- Congratulations to Mark & Laurie Danaher on the purchase of their new home! ☺
- Congratulations to Scott & Kathy Demsey on the purchase of their new home! ☺
- Congratulations to David & Marcia MacNiven on the purchase of their new home and the birth of son Lucas David, he joins Jack Harrison to make it foursome. ☺ That's a busy month, a new house and a new baby!!! ☺
- Our condolences to the Berling family on the passing of Fran's father, a wonderful man, husband, father, grandfather, uncle and person.

Below Your Means

This is the true key to financial success, living below your means. I see it at every level of income, people tend to live just at or slightly above or below their income. This is a recipe for disaster because once anything goes wrong, the house of cards comes tumbling down. Our prescription is to save 20% of your gross income first, then build your lifestyle around that basic tenant. If you do that, you'll never have a financial worry, ever. Saving that money will provide with a great rainy day fund, a healthy retirement, and a means to do what many only dream of doing during a lifetime.

American's have become known around the globe as shopaholics who cannot save and are lacking discipline. This is clearly true for a percentage of our population but not the majority of it. The last 18 months has forever changed how people view the world. No longer are people spending first and asking questions later, they're thinking about it real hard before spending any money. Once they decide to spend, credit isn't as available as it once was so if you were living above your means that game is over.

Nobody has ever said to me, Mike, I saved too much money or I started saving too young. It's always, Mike, I didn't save enough money or I started saving too late. Don't live a life of regrets, keep it simple and live below your means, nothing bad can come of that and you'll eventually get so far ahead you'll do things you never dreamt of doing. ☺ ☺ ☺

Predatory Politicians *Continued from page1*

out there. What isn't being addressed is the fact that the government continues to want everyone to own a home, regardless of their ability to pay for said home. The reality is that not everyone is meant to be a homeowner and not everyone wants to be a homeowner. Home ownership drives the economy so the politicians are trying to mandate it to push things forward. The mandates to have low income people own homes should be going away, not getting more and more complicated by just piling new laws on top of old, dysfunctional ones. There should be a financial aptitude test any potential political candidate must take and pass, because clearly they don't have the foggiest idea how money works. If the test is failed, they should be barred from ever holding any office in this country forever.

The mortgage lenders and mortgage brokers didn't cause the real estate bubble. They didn't force people to buy homes, they didn't force people to get mortgages. Demand for real estate, through cheap loans that have gone bad was created by the Federal Government through short sighted legislation. The mortgage brokers who are under scrutiny today had to sell their loans to someone, and to whom did they sell the loans they originated? They sold most of their loans to government sponsored entities such as Fannie Mae, Freddie Mac and the FHA. Each of these entities is either a Government agency or a quasi government agency forced to comply with government mandates. Think about this, the government declared that everyone should own a home so they force financial firms to lend to people who they know damn well cannot pay it back, then the government buys back and guarantees the loan from the financial institution they forced to write it. Now Fannie & Freddie are bankrupt.

Real estate is also going down in value and that cannot be stopped, but what do the politicians do, provide a tax break to buy a home and keep rates low. Both are artificial measures to put a floor on real estate prices that are eventually going to go where they need to go. The market cannot be stopped so the bailout, tax credit and assistance nonsense should stop now. Rather than fix the real issue they keep attacking it from the side, adding fuel to the longer term fire. Who pays for this short sighted legislation? You & I do as taxpayers of this nation.

The real predators out there are not the bad apples in any given industry. Even though they're a problem, they'll ultimately get caught and brought to justice and they're a very small percentage of any industry. The real predators today are the lawmakers who cannot understand how laws they propose today will impact all of us later in life. The impact won't be in a year or two, it'll be in decade or two and it'll be life altering. It's time for people to require responsible government. It's pathetic right now what government is doing. Let's fix what is in existence right now before we make any new, dysfunctional programs moving forward.

Money Quiz

This month's challenge is to tell me how big, by market capitalization (# of shares X price/share), the biggest stock in the S&P 500 was on 12/31/1999. On 09/30/09 it was $330 Billion in market capitalization. Last month's quiz was won by Louis Martinelli, 13% of people with an employer sponsored retirement plan declined to participate in the plan. The winner will enjoy lunch/dinner on us at Chili's. 10/19/09:05☺

Credit *Shrinkage*

The inflation worries people are hyping today, pushing gold and other commodities as a hedge against inflation are likely a nonissue in the short term. Remember, as an investor, to do well you must buy assets when they're cheap sell them as they get to fair value, not buy them when they're expensive and hold them for a fall. Commodities today are outrageously priced, and likely unsustainable at these levels. Mines around the world have cut capacity, many by more than 50% and China just recently limited output on Aluminum and other metals to cool off excess industrial production. For prices to be at all time highs with plenty of supply and a shrinking demand makes zero economic sense.

For the first time, we can now quantify how much credit has disappeared from the financial system in the past 18 months. PIMCO has done research on the consumer credit available to buyers and their data shows that over the past 18 months there has been an elimination of $2.5 Trillion in consumer credit alone. Business data will come out shortly and I suspect that it has an even more extreme reduction in credit. Government stimulus of even $1.0 Trillion means we have a net decrease in the money supply and in theory, deflation should be rampant. It certainly is in many areas, but not at threatening levels. The system is so global today, so just looking at America's numbers distorts reality because money flows intra country and intra continent on a daily basis. Liquidity here must be compared to liquidity across the globe to get a fair assessment of what is reality and what is not. I'm not calling good old Uncle Tom to buy my jewelry, what are you doing?

100 Again

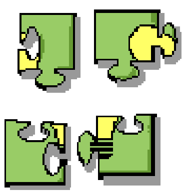
2008 will go down in the annals of history as the second year on record where 100 or more banks failed. 1992 was the last time this happened following the Savings and Loan fiasco of the late 1980's. This isn't news, we've known this was coming for some time now. It sounds scary on the surface and if you're stockholder of a failed bank then it is indeed quite painful. There are over 8,300 FDIC insured banks in America holding trillions in assets. During the Great Depression 9,100 banks failed, representing 33% of the American banking system. In the 80's and 90's 818 banks failed, which at the time was 5% of the American banking system. Today there are far fewer banks, but many of them are enormous. (Cup would say they're big-huge. ☺) There is a lot of speculation as to how many banks will fail following the wake of last years train wreck, estimates range from 2-10% of the current banking system. If this range has any credibility whatsoever, which I'm not sure it does, that means somewhere between 160-800 banks will fail. There is a "watch list" the FDIC maintains but is not publicly available and I believe there are around 400 banks on the watch list. Of those being watched, not all will fail of course and many may do just fine.

The most troubled banks are likely in California, Florida, Georgia, Illinois, Texas, Minnesota & Washington. No state is failure proof, but some regions have a much harder hit economy and real estate market. Banks are directly tied to the value of their loans. I believe most of the financial meltdown is behind us, but it will take a few years for things to work their way through the system. This mess also creates massive opportunity for healthy institutions. When a bank is taken over by FDIC, another healthy bank is the beneficiary of it as the FDIC eats the losses and the assets are then sold to a new bank at fire sale prices. There is going to be a lot of money to be made on regional banks in scooping up their unhealthy competitors from the FDIC in the coming years. Many have already made such acquisitions, but the fruits of the deals will not be realized for a few more years.

People are also predicting the coming commercial and credit card wave of default issues that is supposed to be as big if not bigger than the mortgage mess. I disagree with the theory completely. Most consumer debt is now in mortgages, not credit cards and businesses had very strong balance sheets coming into the recession. Federal bank regulators have also issued very clear instructions for banks to rework commercial loans before they become a problem. This is a rare event and a plus to see a regulatory body on top of their job and doing something that will avoid some panic. Banks are happy to rework loans to longer duration, lower rate than have them go bad. The estimate is that $770 billion of commercial loans will mature in the next 5 years. The new rules and new conservative lending standards should provide for a relatively smooth ride through this process. ☺

Inspirational Quotes

- You get the best out of others when you get the best out of yourself, Harvey S. Firestone
- Sooner or later, those who win are those who think they can, Paul Tournier
- Education is what survives when what has been learned has been forgotten, B.F. Skinner
- A very small degree of hope is sufficient to cause the birth of love, Henri B. Stendhal
- Anyone can hold the help when the sea is calm, Publilius Syrus



We can piece the puzzle together and make your money work for you. ☺

Kids Korner

Have you made your children decide on various economic value propositions yet? It's never too early to have the kids experience this exercise and begin to create their own economic value system. We don't hide much from the rugrats economically, outside of Hannah asking for our net worth. ☺ It's important to have them realize the financial impact their decisions are going to have. Try letting them decide on buying Christmas gifts for some family members. Give them a budget and have a conversation about how many gifts need to be bought, how many people you must buy for, and see what they come up with. It's amazing to see just how quickly they become great shoppers. Not good, but great shoppers and they'll fill the order on budget. This type of exercise gives them an appreciation for the economic reality of our world no other can. I'd love to hear about any experiences you have with this, please keep us posted. ☺ ☺ ☺

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If anyone you care about would benefit from receiving this newsletter, tell us who they are and they will be included on our mailing list. They'll certainly appreciate you thinking about them and having their best interests at heart.

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