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## Do You Know Where Your Net Worth Is Tonight?

Misunderstanding net worth causes the wealthy to feel financially inflexible, and the high-income poor to feel or act as though they were rich. The inflexible wealthy do not appreciate the opportunities of their wealth, especially if current income is modest. They do not make tax-saving lifetime transfers to heirs or significant charitable donations because they fear destitution. Meanwhile, persons of low net worth, especially the elderly, make numerous small charitable contributions from funds that would be better saved to care for themselves instead of to care for others. Studying and understanding net worth—both the concept and the arithmetic—lead to actions likely to preserve wealth over generations.

Net worth is the only reliable measurement of financial health. No other statistic works—not income, not realized gains, definitely not the value of a home or of vacation property, not future earning power. Personal (or corporate) net worth describes in a flash the financial capabilities of an investor and the degree to which he or she can participate in the economic game. When properly understood, “net worth” is similar to “strength” or “wherewithal.” It is the rational, precise measurement of a starting point—it is the means to achieve a goal. To improve net worth is the most compelling of all personal and corporate financial policies, for to improve net worth is to be able to be more productive.

A large obstacle in the path to understanding net worth is comfort with the status quo, even if negative. These examples illustrate:

- Many young professionals enter the work force with negative net worths arising from heavy reliance

***“Net worth describes in a flash the degree to which an investor can participate in the economic game.”***

on student loans and credit cards, and they become comfortable with this financial condition. Few make extraordinary attempts to quickly pay down loans. Instead, they buy cars, houses and consumer items, leaving themselves in the negative for years. As long as monthly payments and personal expenses do not exceed monthly income, no anxiety is felt, and change to a positive net worth is slow.

- Acquiring real estate, especially homes, involves debt creation and potential negative net worths should real estate values decline. Few consider the risk because home ownership is an important achievement, a significant part of our participation in the national status quo. Also, real estate investors usually do well. On the other hand, some California home owners are not in a position

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to sell because sale proceeds would be less than mortgage balances. Inability to sell is no fun for persons who want mobility, or who want to change life styles at retirement. Negative equity in one investment, or negative net worth in general, restricts personal flexibility. Saving more, or creating less debt, preserves future possibilities.

•Nonprofit organizations, such as neighborhood associations, health-related enterprises and arts groups, become “positively comfortable” with present circumstances. The term refers to the common practice of maintaining a large cash balance (often earning as little as 3 to 5 percent). An institution that is “positively comfortable” is governed by trustees who want lots of cash in the bank. They want a “rainy day fund.” They are reluctant to spend a portion of the fund on benefits, instead assessing members for contributions. Individually, trustees might acknowledge that the fund is a poor investment, but obtaining a majority vote for change is not feasible. The com-

mittee of trustees is too comfortable to change. Enjoyment of the status quo is powerful. Conversely, I am aware of a nonprofit that has had a negative net worth for years. Trustees of this nonprofit are “negatively comfortable.” The books have been negative so long that no one feels the need for change.

•Estate planning is particularly uncomfortable for investors, and most estate planners believe that their clients do not appreciate the concept of net worth. Estate planning is the only portion of financial planning that has the purpose of reducing net worth at (or before) death. Some planners argue that fear of death, procrastination, intrafamily politics, and other emotional issues restrain creation of solid estate plans. I disagree. I believe that effective, comprehensive estate plans are not created because investors cannot tolerate a change in the status quo. Any proposed transaction that reduces balances in checking and brokerage accounts causes consternation of a magnitude that prevents action. Nevertheless, if investors understand net worth, if understanding exceeds anxiety, if projections are reviewed and accepted, if resistance to change is overcome, estate settlements can be smooth and profitable for both charitable and personal beneficiaries.

•“Rate of return” is a misleading statistic. Rate of return is useful for headlines, mutual fund literature, and consultants distinguishing between money managers. However, for taxable investors, rate of return does not clearly elucidate the contribution to net worth made by an investment program. The biggest problem is taxes. The second biggest is fees. Suppose that two investment programs each show a rate of return of eleven percent, or approxi-

mately \$11,000 on a \$100,000 investment. One of the investments (probably a buy-hold stock strategy) in-

***“A new statistic,  
“return to net worth,”  
would allow  
comparisons of  
investments, no  
matter how diverse.”***

curs no taxes or fees. The other investment realizes long-term capital gains of \$4,000, producing a tax of \$720 (at the new, low 18 percent rate), plus fees of \$1,000. Both investments have the same rate of return, but the first investment contributed \$1,720 more to net worth. If this \$1,720 itself were to earn 14 percent each year for ten years, it would become \$6,376.42 in ten years. The first investment is more beneficial than the second, but rate of return” does not highlight the difference.

Confusion about net worth is not limited to individuals. For example, professional consultants often are asked how to measure the results of an investment program—by income or by “total return.” To the experienced, “total return” is the accepted method. If expenditures are less than the sum of income and appreciation, net worth will grow to handle future needs and more resources can be spent on current needs.

An explanation of the power of net worth is set forth in *Wealthy and Wise* by Claude Rosenberg, Jr. (Little Brown and Company, Boston, 1994). He states:

“In the search to identify what constitutes surplus funds, it is criti-

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## Chaos at Sunbeam

Bernard Baruch is reported to have said, "The best time to buy a straw hat is in winter."

In more ways than one, Sunbeam is out of doors, freezing. The price of its stock dropped more than 70 percent in less than 6 months. The board is outraged, managers have been fired, and the

***"In more ways  
than one,  
Sunbeam is out  
of doors,  
freezing."***

Securities and Exchange Commission is looking at the books. Events are moving so fast that the assumptions of this commentary (written early July) might be erroneous by the time you read it (mid-August). Additional bad news could put the stock down further, or even off the exchange. Good news, such as a takeover by another company, could put the stock up 50 percent. This reality is the essence of risk and reward.

What is the real value of Sunbeam? Is it 53, the high earlier this year, or \$8.19, the low in June?

Although the correct answer will not be known for five or ten years (by hindsight), investors must respond now. Investors must decide whether fundamentals will improve enough to make Sunbeam a good (or fabulous) investment, or whether chaos will continue to oblivion. The decision is intuitive. It must arrive from a "gut feeling."

Sunbeam is a classic American brand name. The Chicago Flexible Shaft Company introduced the

name about 1910. It gained strength in the 1930s with the introduction of the Sunbeam Mixmaster, the Shavemaster Shaver, the first automatic coffeemaker, and the first pop-up electric toaster, followed by hair dryers, humidifiers, ice crushers, knife sharpeners and massage pillows. New products in the '50s and '60s were the Sunbeam Egg Cooker, plus frying pans, electric blankets, snow blowers and rotisseries. Experienced cooks will not forget the Osterizer food processor created in 1946 by the Oster company, acquired by Sunbeam in 1960.

Its well-known brands today include Coleman, First Alert, Mixmaster, Mr. Coffee, Oster and Osterizer, Powermate and Sunbeam. Among these brand names are products reputed to be the best in their fields, from sleeping bags and smoke detectors to outdoor gas lamps and food processors.

The company's wonderful history of quality and innovation took a back seat to modern finance when, in 1981, the company was acquired by a go-go conglomerate, Allegheny International Corp. Those were the days of mergers and acquisitions when executives made big names for themselves by making deal after deal. A strong stock market hid underlying inefficiencies until the late 80s when Allegheny, and others like it, went bankrupt.

From 1988 until today, the financial history of Sunbeam has been chaotic. An investor who bought Sunbeam from creditors was booted out as chief executive officer in 1993 and was replaced by an executive from General Electric. In 1996, the GE executive was replaced by Al Dunlap, an Army paratrooper who gained fame by reorganizing Lily-Tulip, Crown-Zellerbach and Scott

Paper, and by writing a book, *Mean Business*, that described his accomplishments.\* By then, Al Dunlap's popular nickname was "Chain Saw Al" because his primary reorganization technique was to down-size (fire employees). A January, 1998, article in *Fortune* seemed to praise him, mentioning that Sunbeam had gone from 12 1/2 to almost 50 during the 18 months of Dunlap's tutelage. (However, some language in the article was not complimentary. For example: "[Dunlap] is always riled about something.")

At Sunbeam, Dunlap continued to chop, replacing dozens of top executives, introducing new products and targeting new markets. He made a deal with the American Medical Association to endorse Sunbeam's "health at home" products, but the AMA later reneged. Dunlap's response was to sue for \$20 million. He also began contemplating acquisitions, as Allegheny had 17 years earlier. And, like Allegheny, falling sales, lower profits and a declining stock, plus bitterness in the ranks, did him in. Dunlap was fired by the board in June, with lawsuits over compensation packages sure to follow. Good products but bad management. That is Sunbeam's history for almost 17 years.

For investors, the future is more important than the past. If Sunbeam's products and reputation are strong, if the financial structure is

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SUNBEAM	
Price*	8 7/8
52-week range	53 - 8 3/16
Dividend	.04
P/E	12

\*July 31

## GIMME FIVE

When is 30 years of experience no better than five?

The answer: no experience might be better than five.

This answer occurred to me while reflecting on a nonprofit's decision to hire someone else. The stated reason was that WP&M had not been in business five years. "Ouch," I said. "What's been happening since 1959?"\*

But my point is conceptual, not personal. The five-year idea is powerful in today's investment marketplace. Consultants and brokerage firms that direct money to professional money managers will not consider managers who have a less-than-five-year measurable track record. Five years is one of those convenient periods like decades and centuries for reporting information, especially rates of return of money managers and investment funds. Personal financial advisors frequently tell clients to evaluate investment programs over "three- to five-year periods." Meanwhile, government produces \$5 bills, and one teenager says to another: "gimme five."

As a criterion, five fails. Let's look:

- Past performance does not guarantee future results. This is stated in every prospectus. Whether the past is five years long or ten minutes long doesn't matter.

- In 1998, a thirty-year-old who started an investment fund in 1993 has five years' measurable experience, as does a forty-, fifty-, or sixty-year-old who started in the same year. But which has the important experience?

- Five years does not include the bear markets of 1974 and 1989, nor the dramatic decline of mid-1987. Should the criteria be modified to state "five-years experience plus at least one crisis?"

- Michael Jordan has been a good player the past five years. Will he be as good during the next five?

- "Mozart. Please be reasonable. You are only ten years old. I need to hire someone with experience."

- "Mr. Gates, I understand that your Disk Operating System works very well, but we purchase only from individuals having at least five-years experience."

- "Sir, you should not buy books from Amazon.com. It has been in business only four years."

The future is not like the past. Innovation is characteristic of the young. Perhaps the best rates of return will be earned by professional investors just out of college. The issue is not five years. The issue is whether experience counts at all. ▲

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\*I purchased my first stock in 1959. WP&M was organized in 1997.

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cal to break the common habit of concentrating solely on income. It also is shortsighted to lower . . . giving potentials simply because the IRS calculates tax deductions based on net income. Money is money, it knows not its source, and it knows not the difference between leftover income and what remains of your assets." (My italics.)

Mr. Rosenberg's goal is to promote more giving to charity. His book contains formulas relating the ability to give to net worth. It is a treatise on the significance of net worth, and it can be read with other goals in mind. Understanding personal net worth facilitates proper evaluation of investment risk and intrafamily transfers. An investor whose net worth is over \$1 million can afford to assume greater risks than the investor whose net worth is \$100,000. Also, the wealthier investor can consider larger lifetime gifts to heirs.

I believe that the financial services industry should begin reporting "return to net worth" in addition to "rate of return." The new statistic could be calculated in two or three tax brackets, and adjusted for fees. It could be a standardized number, applied uniformly to all investments, regardless of how the contribution to net worth is made. It would not matter if the contribution were in the form of tax reduction, tax avoidance, tax deferral, taxable income, or gains. All investments would report the same number. It would allow investors to accurately compare all investments, no matter how diverse, such as mutual funds, variable annuities, farming enterprises, limited partnerships, and even home ownership. The purpose of financial and investment planning should be to improve net worth. The new statistic would focus attention on that goal. It would help us all to make the best financial decisions. ▲

## Some Spice in Your Investment Life

Investor fascination with specific products and services, such as the anti-impotency drug Viagra, or the potential power of the Internet, has been a stock market staple since at least 1600. An early fascination was spices.

Since Roman times, traffic in exotic condiments from east to west has been profitable, and in the sixteenth century the Dutch, Portuguese and English became merchants of spice. The great explorers opened shipping routes to the east primarily to import spices, for the value was so great that a ship arriving in London with only one-sixth of its cargo intact could still make a profit. What was a basic and inexpensive culinary additive in south Asia became an exotic luxury in the west, a symbol of service and class.

### The First Common Stock

Like modern technology, the spice trade had its heroes. The Bill Gates of 1600 was James Lancaster, who, from 1591 to 1594, led an unsuccessful voyage around the Cape of Good Hope, only to return as a survivor, a man of experience, a top sailor. Lancaster was among the original 218 who petitioned the crown to charter a business known as "The Company of Merchants of London Trading in the East Indies"—The English East India Company, one of the first enterprises financed through issuance of a common stock. A fleet of four ships sailed from Woolwich in February 1601, led by Master James Lancaster on The Red Dragon. They returned September 11, 1603, with a cargo of spices and grand stories of life-

threatening weather and lost rudders.

### The First Dividend

Unlike today's corporations which have infinite lives, the first English syndication was for one voyage only. The assumption was that investors realizing a profit in one voyage would readily subscribe to the next, but these wealthy speculators were not pleased when the first distribution (dividend?) was not paid in cash. It was paid in pepper. Sensing resistance to a second attempt, directors stated that for every 250 pounds invested in the first voyage, 200 pounds had to be reinvested in the second. For the sake of the company, it could be no other way, because a new planned subscription of £60,000 attracted only £11,000. The second voyage finally was approved with orders to bring back cloves, nutmeg, mace, cinnamon and raw silk—"anything rather than pepper."

Interest in the voyages rose and fell like modern stock prices, depending on recent profits. The combined profits of the first two voyages was 95 percent, rising to 234 percent for the third and fifth. In 1609, His Majesty King James I granted a new, more favorable charter, and subscribers included influential courtiers and peers, giving more credibility to the company's stock.

Exports, of course, were important, and the first ships departed with precious metals. Later departures carried English broadcloth believed to be useful in Japan. Though this venture failed, the English were gaining valuable experience, including experience in commerce between the Asian islands. In addition, the company's ships were ordered to seek profit in the Arabian Sea, whose

coast line included lands then known vaguely as India.

The system of financing each voyage independently caused competition and quarrels among the English, a situation somewhat resolved in 1613 by issuance of The First Joint Stock to finance one fleet every year for four years. The total

***"The Bill Gates of the spice trade was James Lancaster, a survivor, a man of experience, a top sailor."***

raised was £418,000, and the Second (1617-1622) raised a colossal £1.6 million. Over the years, the success of syndications varied widely. Like today, investors responded to the past instead of to the future. Raising money after successful voyages was easy; following less successful ventures, the company raised smaller amounts. After years of public disputes over the company's monopoly position (like Microsoft's today?), Lord Protector Oliver Cromwell and Charles II issued an exclusive charter to the company, resulting in issuance of the New General Stock, a permanent security insuring continuity of capital. More than £786,000 was raised. The new charter also authorized the company to fortify and to colonize its establishments. In effect, the Crown authorized the company to wage war. The company was conducting more than half the trade of the entire nation. The road to English hegemony was under construction. Meanwhile,

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## Spice, continued from page 5

stock worth £100 under Cromwell in 1657 was worth £70 in 1665, £245 in 1677, and between £360 and £500 in 1683.

### The Rest of the Story

The remaining history of The English East India Company involves famous stories of Bengal, Siam, Canton, conflicts and piracies, international conspiracies and military incidents as far away as Cuba. It involves complex relationships between European and Asian nations, between kings and company directors. Products traded changed from spices to cotton to tea, and attitudes changed from aggressively entrepreneurial to burdensomely bureaucratic. Like stocks today, price changes occurred based on both news and rumor. During the eight months following April, 1766, the company's stock doubled on news that an annual surplus of £2 million from operations in Bengal would pay for all of the company's operations elsewhere. Yet in less than 6 years, famine eroded revenues, the stock price fell, the dividend was suspended, and directors sought a loan of £1 million from the government. (Like Chrysler in 1981?) By 1813, the

company had only a partial monopoly on the China trade, and by 1858 it was declared insolvent.

No modern company can trace a 250-year history, but we can relate to the highs and lows, to the cycles of euphoria and despair. (See story on Sunbeam in this issue). The English East India Company did what companies do today. It sought authority, power and capital. It negotiated with government, tried to avoid regulation, and proclaimed righteousness in the face of resentment about its monopoly. Were it alive today, it would seek new capital through investment bankers or possibly through the Internet. It would have a government relations staff and attorneys. It would make contributions to candidates and attempt to defeat its detractors. Companies today—and the risks investors assume—have changed little. The 218 petitioners of the year 1600 are like you and me. They placed risk capital in the most promising businesses of their times.▲

Information herein is from The Honourable Company, A History of the English East India Company, by John Keay, Macmillan Publishing Company, New York, 1991.

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not too precarious, Sunbeam might have a profitable recovery. An analyst I respect commented that every company encounters bumps in the road. Smooth, uninterrupted growth is abnormal. Business is more like ocean waves and swells that sometimes have direction and other times conflict in an incomprehensible pattern of motion. Investors who see value in Sunbeam's products and who have faith that a less flamboyant executive can reformulate the team should consider Sunbeam as a good speculation, as an opportunity at a low price. They should consider it "a straw hat in winter."

Sunbeam is a high-risk investment. Investors acquiring the stock must accept the risk and must be prepared for the possibility of loss.▲

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\*Management by the famous and flamboyant is inherently dangerous to investors. Managements of strong companies operate quietly, out of the limelight. Keeping up a public image requires time better spent on day-to-day management.

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