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Corruption

Note: A reader of the following took umbrage at the absence of a moral conclusion. She asked: "Aren't there degrees of self-dealing, which, at one extreme, become simple stealing?" Your reactions are welcome at john@wpam.com.

Three methods allocate wealth: inheritance, the competitive market, and self-dealing. In some countries, the last is called corruption. In our country, a common name is "shareholder democracy," a euphemism for quiet decisions by insiders.

Allocation and preservation of wealth through inheritance is widely accepted in most nations, though some philosophers suggest that second and third generations, persons having nothing to do with the wealth creation, should share the wealth by paying estate and inheritance taxes. Present policy in the United States rejects this philosophy through legislation that will eliminate these taxes by 2010 (but as the law is now written, reinstate them in subsequent years).

Obtaining wealth through competitive markets also is widely respected. Persons with unusual skills, such as heart surgeons, are expected to earn more than workers without skill. The wealth of inventors is a direct function of the commercial success of their inventions. Hence, Bill Gates, who commercialized the Disc Operating System and the Windows operating environment, is one of the world's most wealthy individuals. The competitive market also divides wealth between those who work the hardest and most effectively, and those who are

less effective. For example, a salesman working 15 hours a day who is a good communicator will earn much more than an individual with an eight-hour-per-day commitment. In entertainment and sports, compensation is directly tied to skill and to public appeal. Movie stars earn fabulous sums because movie patrons purchase tickets to their films. Their compensation, as well as rewards to studios, producers and directors, is measurably related to the quantity of tickets sold. Professional athletes operate in a similar milieu. Their contractual income is determined by competitive bidding between teams. In turn, the capability of a team to bid is determined by its ticket sales and media market penetration. A star player increases market penetration. He or she draws crowds. (In quiet years, when the Indiana Pacers were not winning and not drawing capacity crowds on their own, attendance always increased when stars Michael Jordan or Shaquille O'Neal came to town.) While our society readily acquiesces to making large payments to stars, high salaries of athletes are more controversial. The reason is that athletes' salaries are frequently on the front page, while movie star compensation is less well known.

Self-dealing, meaning the opportunity for a person to arbitrarily determine his/her own compensation, is least understood, at least with respect

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to its economic impact. For example, a Guatemalan taxi driver concludes, incorrectly: “The reason our economy is weak is corruption.”

His lament confuses an economic assumption with personal resentment about the method of distributing wealth. He is alleging that illegality and dishonesty weigh heavily on productivity. In fact, the opposite might be a superior description of reality. The taxi driver perceives corruption to include bribery to obtain a right or opportunity, quiet diversion of funds from one hand to another, such as moving funds intended for bridge construction to building one or more private homes and yachts, and avoidance of paying a “fair share” of government expenses through tax fraud. Unfortunately for the taxi driver’s strongly held belief, none of these activities slows the velocity of money. The businessman or politician who builds a home with ill-gotten funds provides numerous jobs. If he is lavish about the effort, perhaps he provides more jobs than does a more straightforward business person. If he saves excess funds, he is giving greater power to banks and insurance companies to invest for projects either in his country or somewhere else. If

tax avoidance is his game, capital merely flows through different channels and to different functions than designated by government. In the most sophisticated systems, “corrupt transactions” are conducted under a set of unstated rules not that different from printed rules and regulations. For example, a border customs agent asks for a “propina” to efficiently process an importation. If he asks for too little, his customers, the importers, as well as his colleagues, think that he is a fool. If he asks too much, he becomes subject to various forms of discipline, some more painful than others. A broken nose, or worse, is not uncommon for a ship’s crewmember who steals more than the “generally accepted” amount of cargo. Knowing the system, importers and ship owners adjust prices to compensate. Governments also acknowledge misdirection of funds by preparing national budgets with revenue projections based on real life possibilities, not on ideal, theoretical assumptions.

The perspective of persons residing in developing countries often includes recognition and acceptance that obtaining service requires direct personal payments. For example, to quickly obtain a marriage license may require a cash payment to the responsible bureaucrat, without receipt, and without knowledge of who gets the money. Probably, government finances the bureaucrat’s office facilities, but does not pay him a “decent” salary, meaning an amount to support a lifestyle consistent with his station. He makes up the difference by receiving cash payments. Rarely do citizens complain about these payments. (In the United States, on the other hand, government salaries appear sufficient to provide an adequate standard of living.)

At the upper end, populations of developing nations appear to accept, even to admire, elected officials who

find ways to live well. Some of these officials, such as the Shah of Iran and, for a time, even Saddam Hussein, are reported to have obtained some of their wealth from official aid programs of the United States. Back home, such behavior is abhorrent. My personal favorite corrupt politician was Orville E. Hodge, comptroller of Illinois between 1953 and 1956. He used his legislative knowledge and skill to obtain a budget for his office \$2.5 million higher than was needed in the previous biennium. Despite this increase, he spent money so freely he ran dry before the end of his term and had to be bailed out by the legislature with a \$525,000 emergency appropriation. He had embezzled more than \$1 million using phony state warrants, misappropriating funds of closed banks, padding expense accounts, making unauthorized expenditures as well as fraudulent contracts, and through plain waste. He was indicted for conspiracy to embezzle state funds. He pleaded guilty and was sentenced to 12 to 15 years in prison. Upon release, he returned to Granite City to work quietly in his sister’s hardware store. A reason he was caught was that journalists noticed a home and personal lifestyle beyond the limits of his stated salary. The larger point, however, is that his actions had little economic impact on Illinois or its citizens. In studies about causes of low productivity and welfare, corruption pales when compared to such nationwide phenomena as literacy, transportation and communication systems, climate, general health, availability of natural resources, and internal societal conflict.

Self-dealing in America is as common as self-dealing in other countries, but we have sugar-coated the process. We have constructed laws,

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regulations and customs that permit several thousand corporate executives to determine their incomes outside the forces of competition and measurable merit. The basis of the system is noncompetitive elections of directors by shareholders. Slates recommended by management usually are elected. Hence, many directors are indebted to the chief executive who nominated them. Prior to election, the candidates for director positions reveal no more of themselves than information in routine biographies. Their personal achievements and philosophies are unknown to the voting shareholders. A biography tells us that a candidate was president of this or that, but does not tell us what he achieved while being in the position. The point is moot, however, because no opposing candidates appear on the ballot.

After their election, directors create a compensation committee that determines how much of the company's resources will be paid to the chief executive, the man who hired all members of the committee. Minutes

of both committee meetings and board meetings are superficial. They state, "it was decided to pay X dollars to . . ." but neither debate nor individual votes are disclosed. Shareholders cannot evaluate directors based on their votes, because the superficial printed record makes all decisions appear to be friendly and unanimous. Interlocking relationships between boards of various companies create another level of mutual dependence among directors, as do supplier-customer relationships. Directors of corporations in the United States all are tied together by a spider web of relationships and traditions that is impossible to penetrate. This is the system that allocates large amounts of wealth to few individuals.

The system fans the flame of public resentment, but it is the only system we have, and who can say that another system might produce inferior results? We are fortunate in two ways. First, most persons who participate in the system are both honest and inclined to make moderate decisions. Second, like the Orville Hodge case, no damage to our economy appears to take place as a result of arbitrary allocation of wealth by the few to the few. Perhaps, if asked, the beneficiaries of this economic system would say: "Well, someone has to allocate wealth."

Two Forms of Financial Analysis

Financial professionals deal with two targets of analysis. The first is securities markets and market behavior. The second is personal needs and responses: human behavior. Rarely does a financial professional have equal interest in both targets.

Many authors, advisors and market news services (such as *Investors' Business Daily*) espouse theories of market behavior. The most well-known hypothesis is "Modern Portfolio Theory," which evolved from a computer's ability to grasp massive amounts of data and to categorize and theorize about the data. Mathematical concepts, such as "alpha," and "beta," plus moving averages and studies of trading volume have appeared from this kind of work, while traditional statistics such as "standard deviation" have been applied to risk assessment. The goal of persons with this mindset is to treat market behavior within scientific models, a broad assumption being that market behavior, like gravity, is a function of provable scientific principles. The primary professional

designation of persons who work this way is "CFA," or "Chartered Financial Analyst," though much good work is done by persons who do not have this designation.

Professionals known as "Financial Planners" compose the main group dealing in personal financial issues and human behavior. The most well-known professional designation for these persons is "CFP®," or "Certified Financial Planner." Other designations are "ChFC," "Chartered Financial Consultant," and "CEA®," "Certified Estate Advisor."

Principals of WP&M have earned these. John Guy has been a CFP® since the late 1970s. Paul Coan recently earned the ChFC and the CEA®. He is working on another educational track that will result in one more certification.

Having both worked as "stockbrokers," John and Paul are also interested in the science of markets. We both started with a large national brokerage firm that provides thorough training in the basics of all financial products and some training in the emerging theories of market behavior. John believes that he has had direct experience with every financial product that exists, although some of the experience is quite limited, such as in commodities, options and hedging strategies. Paul has had similar experiences, though over a shorter time period (five years, compared to more than 35 years.) Guess which one goes on Medicare this month? Guess which one is active now in the Financial Planning Association.

We hope that our mix of experiences with both personal issues and investment securities benefits our clients and colleagues.

Disclosure

The Financial Planning Association and others, including a consumer group, are advocating a rule that would require account executives of investment firms to be treated as fiduciaries under federal securities laws. In practical application, this would mean more disclosures, usually accomplished by handing clients and prospects additional prospectuses, Federal Form ADVs, and pamphlets. The problem is: More disclosure is less.

During the past month, my mail box has been filled with lengthy communications from banks, mail order distributors of pharmaceuticals, brokerage firms, issuers of credit cards, and utilities, telling me in small print about their so-called extraordinary efforts to protect my privacy. About one third of the total space of my brokerage statement is devoted to disclosures about conflicts of interest, principal transactions, and research specific to the stocks I own, including “outside” research offered by “third parties.” During routine visits to medical providers I have been asked to sign various disclosure documents about privacy, risks of treatment, outside businesses owned by the providers, and insurance company relationships.

BOTTOM LINE: The weight of disclosure documents is greater than a human can bear.

Erata

In the November, 2005, edition of this newsletter, the last paragraph of a note about Mark Twain should have read: “Toward the end of his life, Mr. Clemens invested all his money in a printing and publishing venture. He watched it carefully. He observed that he was losing everything. He became almost destitute.” In the last paragraph of a note about predicting prices of energy and other items, we should have said: “If you are investing based on potential effects of a known event, you are starting ten yards behind the line of scrimmage.”

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Developing Countries

In the words of a fictional economist: “. . . so divide everything into two hundred million equal parts. Everything [in America] that is fabricated. Steel mills, speedboats, cross-country power lines, scalpels, watch bands, fish rods, ski poles, plywood, storage batteries, everything. Break it down into basic raw materials and then compute the power requirements and the fossil fuels needed to make everybody’s share in this country. Know what happens if you apply that formula to all the peoples of all the other nations of the world?

“You come up against a bleak fact, Travis. There is not enough material

on and in the planet to ever give them what we’re used to. The emerging nations are not going to emerge—not into our pattern at least. Not ever. We’ve hogged it all. Technology won’t come up with a way to crowd the Yangtze River with Muñequitas.¹ Nobody in the world will ever live as well, materially, as we once did. Brazil might manage it. But no one else.”

These are the thoughts of “internationally known economist and lecturer” Meyer, as told to Travis McGee, in the novel *The Scarlet Ruse*, by John D. MacDonald, 1973, when our population was closer to 200 million.

¹ Small boat used as a tender to Mr. McGee’s large boat, the Busted Flush.

When Not To Invest

Thirty-five year’s experience convinces me that the weakest investments have the largest prospectuses and greatest number of disclosure documents and disclosure items to be initialed by investors. During the last half of 2005, I ran into three investors who either had invested in variable annuity contracts or were transferring funds to do so. The ones that pained me most were contracts held within the otherwise marvelous tax-deferred environment of an Individual Retirement Account or similar qualified plan. The primary benefit of an annuity contract is tax deferral. Placing the contract in an

IRA creates an expensive redundancy. Insurance companies are aware of this difficulty. They deal with it by asking purchasers to sign or initial appropriate disclosures. Our investor who transferred to an annuity contract, inside an IRA, initialed ten different disclosures. If he had analyzed each one, and all together, he would not have made the transfer. Unfortunately for him, the significance of each disclosure individually was buried in the obligation to sign them all. In other words, more disclosure meant less understanding.

Good night, Dorothy. You done good.

