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## Parental Love; Family Economics

**M**ortgage loans from parents to adult children produce inferior economic results, but become metaphors for solid, loving, parent-child relations. By profession, financial planners first evaluate the economics.

Home buyers usually borrow to acquire their property. The two sources of capital are personal loans, such as between parents and children, and private mortgage lenders. The economics favor borrowing from private lenders.

Private mortgage lenders provide valuable services along with the capital, including:

- Assurance that the seller has clear title.
- Appraisals providing confidence both to the lender and to the buyer that a fair price has been paid.
- Automatic collection of funds from the owner to pay real estate insurance premiums; all parties are assured that insurance premiums are paid even if the owner is traveling or incapacitated on the due date.
- Collection and payment of real estate taxes, and documentation acceptable to the taxing authorities that taxes have been paid.
- Precise calculations and reports of annual deductible interest payments, as well as amortization schedules.
- Proper recording of the mortgage and the deed.

- Automatic deduction to thrift accounts of mortgage payments.

These services are immensely valuable. Combined, these seven services protect the owner from legal challenges, as well as eliminate the substantial burden of writing monthly checks or the risk of forgetting to write a check for taxes or insurance.

Theory of investment return also favors utilizing a commercial mortgage loan instead of a personal loan from parents. The assumptions of this hypothesis are:

- the mortgage loan runs 15 years with an interest rate of 8 percent;
- the lender's income tax rate will be 29 percent;
- the after-tax total return on an investment portfolio will be 9 percent for the same 15 years.

Under these assumptions, a \$150,000 mortgage loan would return 5.6 percent after tax for the 15 years, producing \$339,664 to the parent/lender (including return of principal), or a gain of \$189,664 to the estate of the parent.<sup>1</sup> On the other hand, if the parent invests \$150,000 in a long-term growth

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<sup>1</sup> The figure will be higher if principal is repaid monthly and immediately reinvested by the parent/lender. My guess is that most parent/lenders do not follow this discipline.

## CHANGE

When I commenced work for Dean Witter in January, 1970, the Dow Jones Industrial Average was 800.36 and the S&P was 92.06.

During my first years, internal account statements arrived in piles four or five days following a transaction. Depending on how many accounts were served by a representative, a pile of account summaries weighed a pound or more—this at a time when brokerage firms dealt only in stocks, bonds, mutual funds, and nonstandardized options.

Since then, the purview of account executives, financial planners and investment advisors has expanded to include financial planning (the CFP designation), modern portfolio theory (asset allocation), insurance, asset management, restricted stock transactions, uses of trusts and other principles of estate planning, retirement planning through savings, such as 401 (k)s and Individual Retirement Accounts, and other subjects. Meanwhile, the large firms offer securities and services not imagined in 1970, such as general asset checking-savings-investment accounts, annuities, certificates of deposit, standardized options, commodity trading partnerships, and hundreds more.

The piles of paper are gone because both account executives and clients can retrieve information instantly from computers, including news, precise account status, and up-to-the-second prices of all securities—and the same instruments that deliver this information also deliver internally and externally produced video broadcasts, as well as e-mails.

*"Change is inevitable, except from vending machines."  
-Anonymous*

What is next? I do not know, but I would not be surprised if clients and advisors soon will routinely interact through video connections, as will parents and teenagers. Imagine, a call from a son or daughter, with parents able to see the entire scene.

Change is good, fun, and inevitable.

## Do What You Love, But the Money May Not Follow

Our friends, the professors, have given the old one-two to investment clubs. Sad to say, investment clubs do not perform well.

According to Brad M. Barber and Terrance Odean, the results of 166 investment clubs from February, 1991, to January, 1997, were distinctly below average. The average club earned 14.1 percent, while a market index returned 17.9 percent. The average individual investor earned 16.4 percent for that period.

Trading costs resulting from higher turnover and from holding a large number of stocks with relatively small commitments to each stock accounted for about one-third of the clubs' shortfalls. The rest of the difference was caused by a tilt toward large-cap growth stocks, away from the emerging technology companies.

Still, investment clubs are fun; members save, learn, and foster friendships.

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## VACATIONS

An article in the February issue argued that vacations do not start until the third day. The reason is that at least three days are required to leave behind daily pressures and to adjust to a new environment. Hence, a three-day vacation must be six days long.

Diane Robert Reynolds, writing in the January 24, 2000, *Newsweek*, said, "I can count on one hand the number of vacations my family has taken together which lasted more than a week . . . . The effects of vacation starvation are all around me . . . . There's hardly a spare hour for pursuits that remind people that they are more than corporate ciphers." She added that while families experience stress, anger, depression and exhaustion, "the V word is almost never mentioned as a solution," and that having come from the European tradition of requiring four weeks of paid vacation each year, "what's died for me is finding a balanced existence in the States. . . . Imagining [my European friends] from my little office, vacation seems less a ticket to paradise than the claim check to a parcel of lost life."

## WHERE IS THE "I" IN I.P.O.s?

**I**nvestors not able to participate in Initial Public Offerings (I.P.O.s.), take heart. It makes no difference.

Newspapers daily tell us about new issues of common stock that double, triple or quintuple moments after release to public trading. These stories present the promise of easy money, prompting public fascination with such phenomena as mutual funds dedicated exclusively to acquiring stocks at their initial offering prices. A walk through the numbers and the circumstances, however, demonstrates no special result.

The long-term total return to net worth of acquiring initial public offerings of common stocks is reduced by the limited availability of potentially profitable stocks, by commissions and taxes, and by normal probabilities.

Investors are most interested in offerings that might rise dramatically during the first day or two of public trading. This result is determined by supply and demand. A "hot stock" has a limited number of available shares, and a large number of potential buyers. Investors are unlikely to obtain a significant quantity of such stocks at the original offering price. If the supply is great, and many investors obtain shares at the offering price, then subsequent price appreciation is likely to be moderate.

Examples of stock offerings that were large enough to be widely available are Conoco, United Parcel Service, John Hancock and MetLife. These are old, quality companies, worth holding for the long term, but none has performed spectacularly since its offering. The most recent large offering was MetLife. It offered over \$2.2 billion dollars of new securities, more than 202 million shares. The stock was up about 7 percent within a day of the offering—not bad, but not spectacular. In contrast,

Akamai Technologies offered 9 million shares at \$26 late last year. The stock soared to \$145. The low trade of the first day was \$110. Therefore, a lot of money was churned between \$110 and \$145. Only the investors who purchased at \$26 earned substantial returns. Since the supply of new shares was small, only the lucky few profited, and most of them probably were allocated 25 or 50 shares each, not enough to change their lifestyles.

Rarely does an individual noncompany-affiliated investor receive more than 50 shares of a hot new issue. Investment bankers do not permit concentration of hot stock allocations, for to do so would be to invite charges of favoritism. In negotiations with a company, investment bankers first allocate shares according to category. The categories are "friends of the company," institutions, and retail. Retail refers to individual investors, you and me. The next step is to divide the retail allocation among branch offices of the underwriters. In many smaller offerings, a branch has 1,000 shares or fewer to distribute among dozens of account executives. Then, the account executive who receives 25 or 50 shares must choose which client will be given an opportunity to buy. Odds are that the account executive's biggest clients get the 25 or 50 shares. This is ironic, because the financial impact of 25 or 50 shares on the personal net worth of a large account is negligible. If 50 shares of a \$25 stock rises to \$145, the gain is \$6,000, a meaningless sum for someone already worth several million dollars. On the other hand, \$6,000 has a significant impact on a person whose net worth is between \$50,000 and \$300,000. Nevertheless, big accounts usually get the opportunities. The bottom line is that few investors can acquire hot issues, and that the benefit of owning is small in pro-

portion to total net worth.

Though initially offered without an add-on commission charge, obtaining and trading new issues is not inexpensive. To acquire a new issue, most investors must sell another asset. The sale of that asset incurs a commission charge. In taxable accounts, the sale also creates a capital gains tax liability. When one client acquires several new issues during a year, these costs are not minor, especially since not every new issue acquired will perform spectacularly. In fact, many decline in price. Also, history does not favor the long-term potential of hot new issues, especially those without large revenues and earnings. Akamai, for example, has yet to report a significant profit from operations, thereby placing it in the high-risk category.

The new-issue market diverts the attention of investors from long-term fundamentals and from principles of portfolio management and net worth management. The chase for hot new issues causes investors to make quick decisions, such as to abandon a quality stock for an unknown company. Investors lose sight of classic concepts of diversification and risk. Most new issues, especially shares of technology and biotechnology companies, have more inherent risk than established companies in energy, communications, metals, and so on. If an investor sells 50 shares of Chevron to buy 100 shares of Akamai, s/he has assumed greater risk. If this rotation is repeated several times (perhaps even 50 times in 1999) the shift to higher portfolio risk is significant.

Investors in hot new issues forget the important goal—growth of personal net worth. The process of continuously selling stocks to buy new issues, then selling the new issues at a

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## Parental Love, *continued from page 1*

portfolio at the 9 percent after-tax rate, he or she will have \$546,372, a gain of \$396,372.<sup>2</sup> By investing funds instead of lending to children, parents achieve a much better result than by making a mortgage loan. Presumably, the child also benefits eventually by receiving a larger inheritance.

A final financial downside for parents making loans to adult children is that most parents must sell assets to raise cash for the loan. Selling generates two expenses. The first is commissions and fees. The second, and usually far more significant, is tax on realized capital gains.

Children commonly turn to parents for a mortgage because they do not have funds to make down payments required by commercial lenders. Parents

can handle this challenge by making a small personal loan and/or by taking advantage of the \$10,000 annual gift tax exemption. For parents having a taxable estate in excess of approximately \$700,000, making annual gifts is very attractive because each \$10,000 gift represents an estate-tax savings of \$3,000 or more. If the required down payment is \$40,000, the parent can give \$10,000 in the first year, while writing a \$30,000, three-year personal loan, and then forgiving \$10,000 of the loan each subsequent year. The loan must be properly documented, and interest must be collected and taxed to the parent.

<sup>2</sup> Recent after-tax total rates of return on investment portfolios have been much higher than 9 percent.

## IPOs, *continued from page 3*

short-term gain, produces large amounts of taxes in taxable accounts. For example, suppose an investor sells 100 shares of a blue chip stock, realizing a gain of \$5,000 and a tax of \$1,000. The funds then are placed in a hot new issue that appreciates \$5,000 before it is sold for a short-term gain, taxed at \$1,450. The total tax on the two transactions is \$2,450. During the time between selling the blue chip and selling the new issue, the blue chip stock increases in value by \$5,000, so that the investor would have been better off to keep it and not to realize the taxable gain. The assumption of this example seems unrealistic. But, in a series of sales and purchases, this is exactly what transpires, because stock prices rise and fall in unison. Hence, at the same time new issues are rising, old issues are rising too. Even in tax-deferred accounts such as IRAs, an investor is better off to keep the old and forget the new. I am aware of one investor who realized gains between December of 1998 and March of 2000 of over \$200,000, all in an IRA. Most of the gains came from small companies; about half were new issues. This amount of gain might prompt jubilation, but the investor should celebrate at another party. Here is why. During the period, his account appreciated 23.62 percent, including realized gains and unrealized gains from hot new issues; at the same time his wife's account rose 33.84 percent. He should have followed his wife's advice to sit tight and to hold for the long haul.

## TO SHAVE. . .OR NOT TO SHAVE

An article in the last issue requested advice for a friend who is attempting to decide whether to shave the few remaining hairs from his head. It asked for opinions.

Ralph, in Colorado Springs, said: "He should do it. I did it, and feel great." Keith, in Indianapolis, said: "As for your friend, it seems only logical that if he has the time, money, self-esteem and patience to wear his hair in his unique fashion, who am I to tell him to cut it? It can't be any worse than many of the butcher jobs today's teenagers so proudly present to their peers. However, if he wants to shower and go in the morning, you can't beat the 'bald and proud' look for comfort, style and expense, but I haven't been able to convince my barber that since I only have ½ the volume, I should pay only ½ the price. Also, I suggest that if your friend comes to any philosophical conclusions, he ought to share them with [Purdue basketball coach] Gene Keady."

Cindy, daughter of my friend, said: "Keep it, Dad. I like it."

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