Why highly paid doctors die broke and how to fix it

Physicians typically make a lot of money, but why is it that over 85 percent of them end up going broke?

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A defective Wealth Operating System & The God Complex

Unfortunately, because they're so esteemed, because we give physicians so much respect, and because we have such high expectations of them, they have a defective wealth operating system. The wealth operating system is how the brain thinks about money. Because there's no financial literacy training in school and really there's no financial discipline, and most physicians don't have a long-term perspective of finances, it creates a tremendous discordance.

There's a culture within academic medicine where you don't talk about financial topics. Unfortunately, this prevents that education from ever occurring and really injures the physicians going forward. The thing is that doctors are supposed to be confident. It's really hard for them to trust someone else, because if they trust someone else, they might appear vulnerable, and they're supposed to know everything in the room. They're supposed to know what's going to happen, and that vulnerability can really injure their personal or professional position in their own heads.

Doctors are used to being in charge. They're used to having people rely on them. They're so used to being looked up to that they find it difficult to seek out advice from lowly business people.

Financial stunting

This creates a financial stunting. The doctor spends years getting their undergraduate and professional degree, while their friends are about 22 when they graduate, and they've already started working and they start to earn a real living. Physicians don't really finish their training until their mid-30s. After years of studying and exams and living on a student budget, they're really ready to splurge when they're finally out making some real money.

Unfortunately, that income jump is one of the biggest reasons for the poor financial habits that doctors have. They might earn well into six figures, but they're also, remember, paying off hundreds of thousands of dollars of student debt, usually.

Lax with finances

Physicians tend to be lax with their finances. That pre-existing debt can seem overwhelming, so sometimes adding on a little additional debt doesn't really seem like it's a big deal. Because doctors have high salaries, they think it's okay to spend accordingly. They don't feel like they've actually made it unless they've got the fancy house, the fancy car. They're taking a vacation. They end up buying boats; they end up having expensive hobbies.

> This lack of financial education and failure to calculate what the real present value of an investment is leads to a tremendously distorted analysis. Some of the things that we're going to be talking about during this presentation, I'm hoping to bring that into insight for physicians. Physicians typically don't understand the concept of velocity of capital. Velocity of capital is if I invest a dollar, is it working for me, or is it just sitting there? Is it just growing just barely enough to get above inflation, or is it actually going to do something for me to help me get somewhere?

Using habits to combat decision fatigue

The other problem is that really, we have decision fatigue. By the end of the day, after a hard, busy day working in the clinic or working in a hospital, making thousands of decisions that are life-saving and making thousands of decisions that are critical and that will really impact a patient's life, by the end of the day, we have no energy left to make good decisions for ourselves. Unfortunately, financial predators, stock brokers, things of that nature know this. They know that it's really hard for us to make a really good decision at the end of the day.

> So, by the time that we get done with our days, by the time that we're done and we're fatigued and we're trying to make financial decisions that are really going to impact us for the rest of our lives, those are the worst decisions we make that day. Habits are just habits, whether they're good or bad. Some of the things that I want to teach people is how do you use algorithms to prevent decision fatigue so you can make good decisions and maintain good habits?

You know, unfortunately, physicians are a little bit narcissistic. The medical field has a self-selection risk. So, it's really the people that were very confident in their abilities; they're exposed constantly to life threatening situations that have a great deal of uncertainty and are very high stakes. It requires the physician to have confidence in decision making. If you don't have confidence in decision making, then the patient loses their confidence in you.

Doctors are prey, for

- Financial advisors
- Friends, family and other communists
- Patients
- Employees
- Attorneys
- Government

The problem is, the physician just doesn't realize it because their confidence makes them think that they're in charge. For the predators, it's a full-time job to prey on you. You just don't realize that you are the prey.

11 common financial errors

1. “Things”

Physicians think that things are assets. So, they buy big houses. They buy cars. They buy boats; they buy planes. They have expensive hobbies. But the problem is, things aren't assets. Things only have value when they're sold. There's the cost of holding the thing, the financial friction of maintaining the thing. If you have friction in holding something, in owning something, then it's not really an asset. It could turn into a significant liability. Really, assets are what you have that generate you money.

2. “Leasing is fleecing”

If it takes money for you to hold onto it and it doesn’t generate you money, it’s not really an asset -- it’s a liability. A lot of times, physicians think, «Well, you know, I’m going to lease that.» The reality is, when you’re leasing something, you’re paying somebody else an interest rate on a thing. If that thing isn’t generating money, if that thing doesn’t generate its own source of income to pay for itself, you’ve made a serious mistake because you’re paying for that thing. Leasing is the same as fleecing. If it doesn’t generate its own income, it’s a liability.

Now the difference is, for example, an expensive car versus an expensive piece of medical equipment. The car is going to rapidly depreciate and it’s not going to generate you additional income unless you decide that you’re going to become an Uber driver at night. But the medical equipment will also deteriorate. It will also depreciate; it will lose value. But the thing is, the medical equipment, if you buy the right piece or do it for the right reason, will generate you a tremendous amount of income.

I usually recommend that if you're going to buy something, let somebody else take the initial depreciation. Buy something that's two or three years old, even in medical equipment. As long as it's still relevant, as long as it still works like it's supposed to, and as long as it's compliant and does the things it needs to do, let somebody else take the hit on the depreciation and you take the value.

3. Being financially exposed to predators

Physicians are constantly exposed to financial predators. The reality is, they just don't realize it. They forget that they need to have disability insurance that's occupation-specific. They forget that they need to have malpractice tail coverage. They forget about umbrella insurance policies. All of these things are necessary to prevent them from being eaten by a predator, and these are some of the most common things that I notice physicians forget.

4. Having no specific life plan

Physicians also typically don't have a specific life plan. It would be the equivalent of driving without a map or a navigation system. You would never go to a new city and go, «I'm in Atlanta. I'm going to go from Atlanta to Savannah, Georgia, but I'm not going to use a map. I'm just going to start driving and eventually I'll figure it out.» You might well figure it out, but it'll take you a lot longer. So, you've got to have a life plan. You've got to be able to take care of your dependents. You have to use systems like wills and trusts, and look at death and disability insurances. Even if you don't have dependents, you might want to look at your own disability. But if you do have dependents, you have to look for life insurance. If you don't have dependents, do you really need life insurance?

5. Speculating is gambling

Sometimes, I notice that physicians think that they're investing, but they're speculating. Speculating is hoping that the price of something goes up. You buy a stock and you think the price is going to double in the next year. That's not investing. That's speculating. Speculating is when things are not in your control. It's doubtful that you personally can buy enough iPhones to change the price of Apple. It's doubtful that Steve Jobs would have listened to you when he was alive.

6. Saving money for retirement

So, it's unlikely that you can create enough leverage in your investment in the stock market to make it anything but gambling. Speculating is gambling, and gambling is not investing. A lot of times, people think that I'm going to save money for retirement, but they don't realize how much they have to save to retire. So, if you actually work out the numbers, you'd have to save about 25-35 percent of your gross salary per year to retire in 20 years using traditional models in the stock market. I'm going to talk to you in this presentation about how to get away from that.

7. Diversification

Sometimes physicians think, «I'm going to ...» I've heard the word diversify, «I'm going to diversify.» But they diversify in different stock or they diversify in paper. They diversify in bonds or they diversify in mutual funds. That's not really diversification; that's still paper assets. Sometimes they're under-diversified. They invest everything into one thing and then they throw the dice. They speculate; they gamble.

8. Ignoring muscle mass

You know, one of the other things that I've noticed is physicians tend to ignore their own health. Muscle mass is the organ of longevity. If you're not healthy, it doesn't matter; your brain's not going to be functioning well into your 70s, 80s, and 90s. You're not going to be able to have mobility. The reality is that your good health determines your financial wellbeing.

9. Jeopardizing your medical license

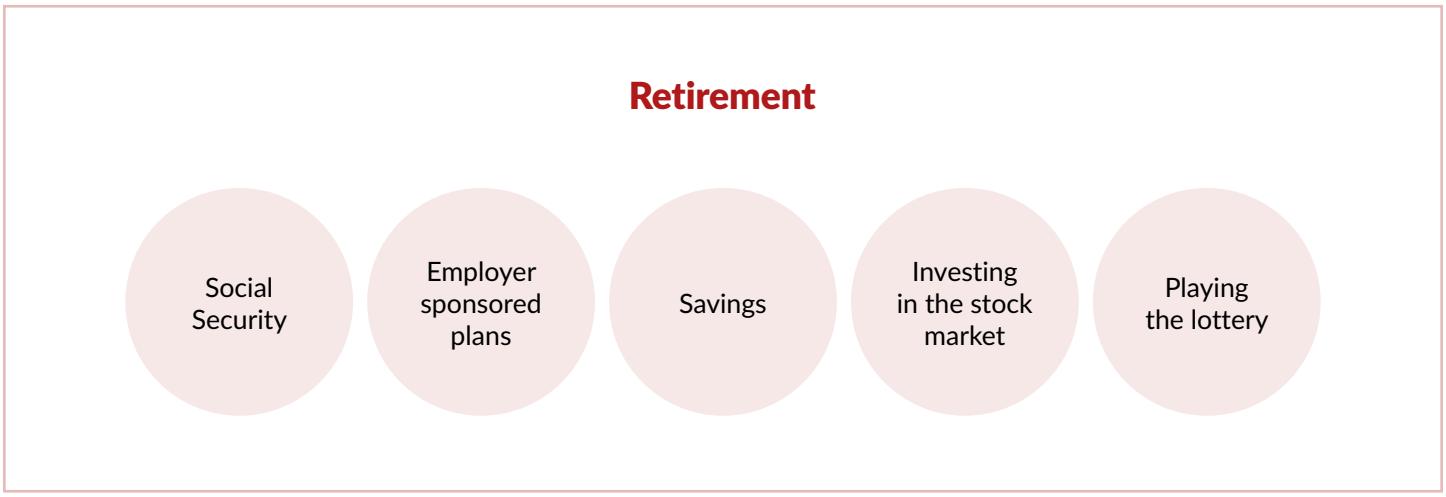
Sometimes physicians do stupid things that jeopardize their medical license—immoral behavior, sex and drugs. They get involved in things, and they think, «Well, I'm a physician, I'm not going to get in trouble for this.» You're precisely the person that's going to get in trouble for this. The entire apparatus of the government is designed to strip your financial resources away and to figure out how it can gain your financial resources that you've spent all of your life working for. But the government itself or other entities can become enriched, and you doing stupid things has jeopardized your medical license.

10. Divorce

Divorce is one of the biggest wealth crushers there is. If you want to take half of everything that you've ever earned and you'll ever earn and give it away to somebody else, divorce is the way to do it. It's a guaranteed way to reduce your net op earning income. It's a guaranteed way to reduce your capitalization rate. It's a guaranteed extra tax for nearly half.

11. Not learning from the mistakes of others

Physicians have a tendency to not learn from the mistakes of others. They think, «I can do this on my own. I know enough.» Sometimes they don't learn from the mistakes of others. There are plenty of examples of other people doing it wrong and you shouldn't repeat that same mistake. That doesn't mean go follow the herd and do what everybody else does, because if you follow the herd and you do what everybody else does, you'll get a generalized rate of return, and that generalized rate of return is probably not going to be that great. So, what you want to do is you want to learn from the mistakes of others. Then, apply those mistakes and look at it in a very granular way, look at it in a very specific way to your particular situation.



It used to be that retirement was easy. We had employer-sponsored plans. We had social security; we had savings plans. We could invest in the stock market. We could even play the lottery and might even win. A lot of people rely on the social security system, the employer sponsored plans and their personal savings to get them to retirement. I don't think many people rely on playing the lottery, but a few do. That lottery mentality is probably what drives a lot of the litigation in the United States. A lot of people think, "I'm going to win the lottery by suing my doctor or suing McDonald's or suing somebody." So, that lottery mentality is one of the thing that drives the entire litigation system, other than the fact that obviously the litigation system's there to protect the small guy.

Retirement: Social Security

So, a couple of comments on retirement social security system. It was really founded in a whole different time. It was founded during the Great Depression. There weren't very many old people in the Great Depression, and they were suffering greatly. In the 1900s, the average life expectancy was 49 years of age, and the social security system was intended for people over the age of 65. So, it was a very small population of people that got over the age of 65, and we were trying to help them because it was very few people. It was only a very small portion of the general population.

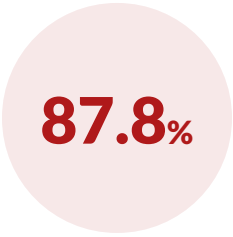
What's happened is by 1960, the average age went to 69. So, that means more than half the people now were utilizing retirement social security plans. Now, in the year 2000s — 2018 – the average life expectancy is about 79 years of age, and it's slowly going up. It's going to continue to rise. But our age of retirement is sitting at 65, which means the vast majority of people are accessing the social security program.

The social security program was never intended to last this long after somebody was retired, and the problem is that the patients and the people that are currently retiring are way sicker than they used to be.

There's a recent study that documented that due to chronic comorbid medical conditions which are now pervasive, only

of the general population is healthy

That means like



of the population is sick, and their illnesses is going to decimate the social security system

Population is living longer, but sicker, with greater financial needs

So, one year of nursing home care in a semi-private room in 2011 was estimated to cost about $78,000. In 2021, the estimated cost is going to be $128,000. That's a 64 percent projected growth rate. Did you earn a 64 percent projected return rate on your stock market investment from 2011 to 2021, 10 years? I don't think so.

2011	→	$78,110
2021	→	$128,100

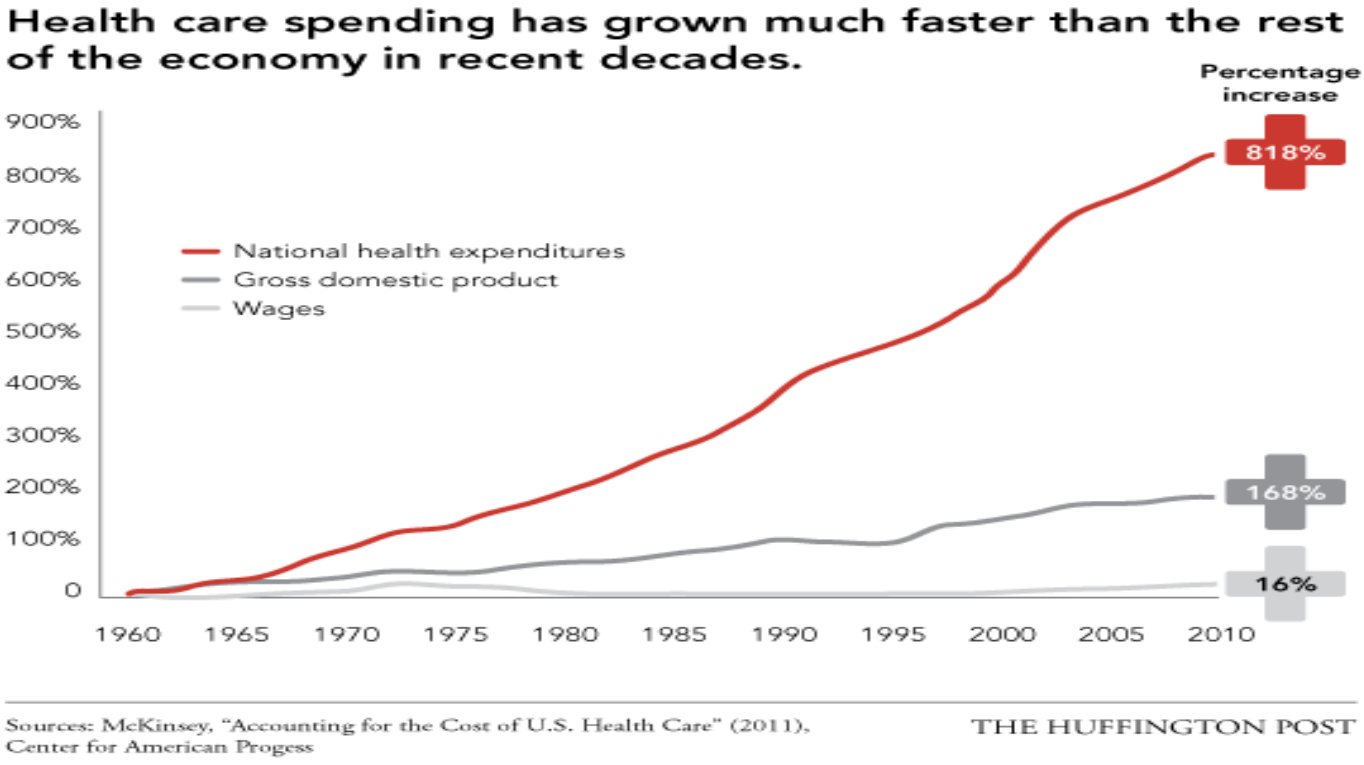
(projected)

64%

projected growth rate

So, where are we going to get the money to maintain solvency?

Because if you look at what the biggest expenditures in the federal government are, the biggest percentage of increase is compared to GDP growth. Our GDP growth was somewhere around 168 percent from 1960 to about 2013. But our national health expenditure went up by 818 percent. Our wages only went up 16 percent. So, our government's getting bigger, and more and more of our dollars are being consumed in national health expenditure, and it's really by several factors. One, medical care is more expensive, certainly. But two, people are living longer, and they're way sicker than they used to be at the same ages. Most of the money spent in health care is really spent in the last 5 percent of a patient's life, their sickest time period.



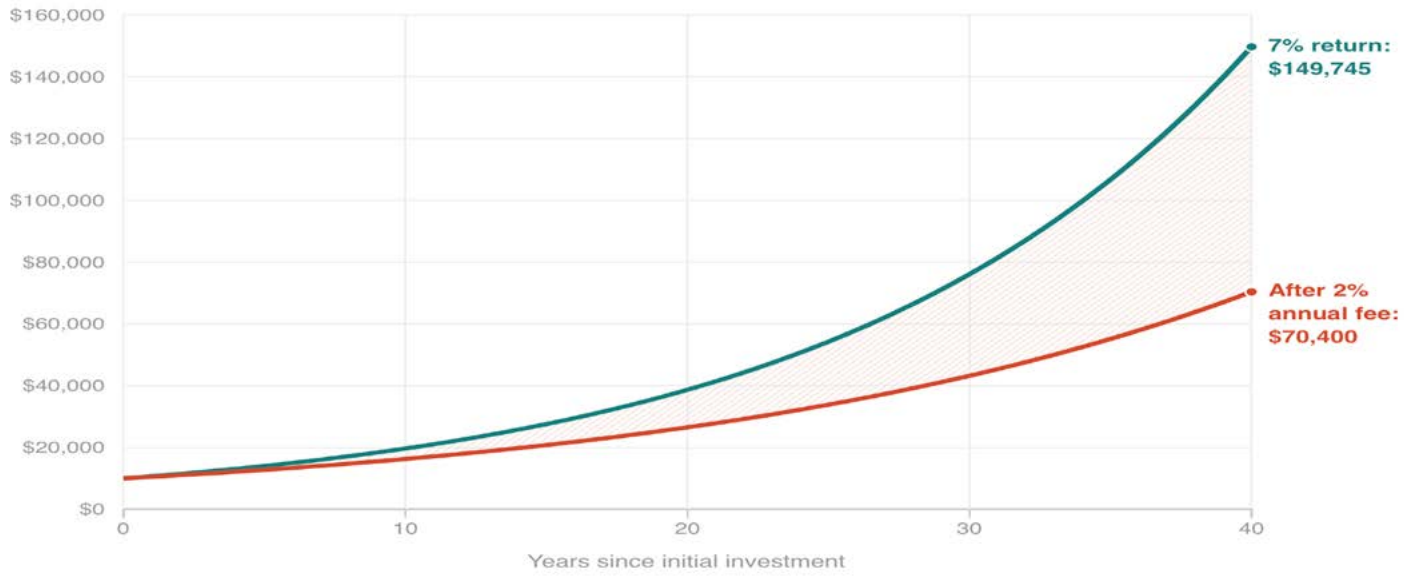
Retirement: Employer sponsored plans

We used to have retirement plans that were employer sponsored. Unfortunately, the passage of the 401K, which really shifted the responsibility from the employer to the employee. It was meant to originally simplify the way that people managed their money, but what it really ended up doing was that it got manipulated by Wall Street. Essentially, it told people that they were incompetent at managing their own money, that they couldn't do it anymore, and so, all of the 401K plans have these custodians, and the custodians is who really manages these plans.

It's allowed Wall Street firms to control about $29 trillion in assets, of which 89 percent are owned by households. The real crux of this is that Wall Street makes money whether you make money or not because it's called assets under management fees. They charge between 0.5 to 2.5 percent of a custodial fee and it's hidden inside the account. So, you don't even realize that they're charging it to you. Those asset management fees over time make a huge difference.

Impact of fees

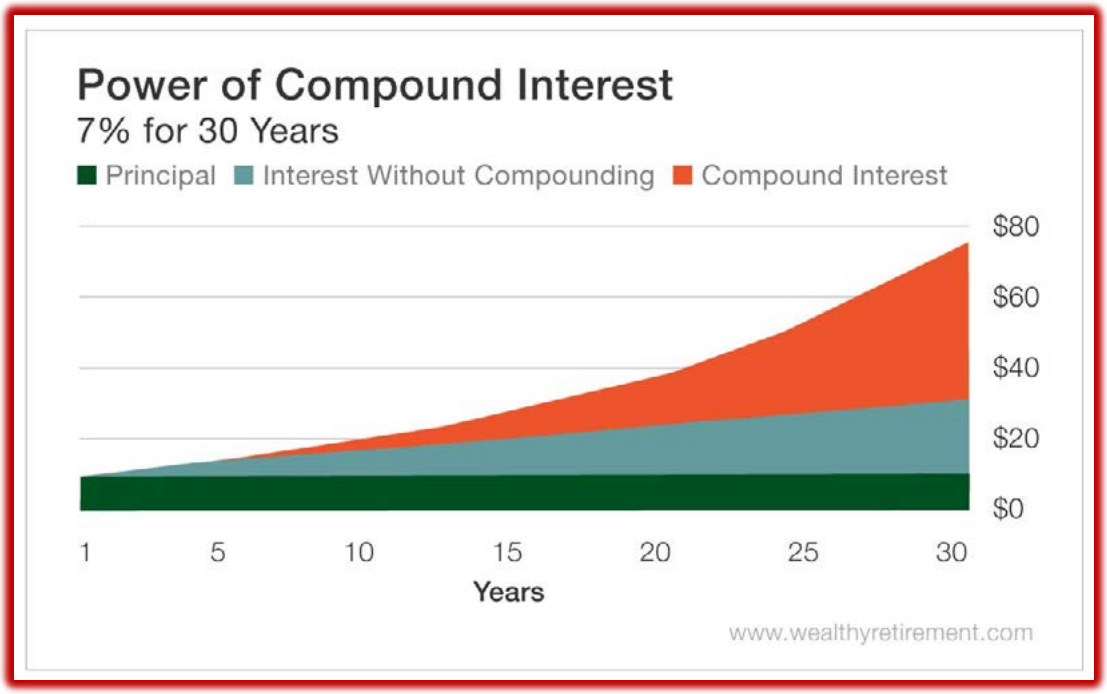
So, let's give you an example. Let's just say that you invested $10,000, and that investment makes about 7 percent return every year, and you invest in it over 40 years. Let's just say that after 40 years that investment would be worth about 149,000 dollars and 745 cents. But if you invested in a fund that charges a 2 percent annual fee, which is pretty typical, you've cut your return to 5 percent. So, what's the difference? After 40 years, your investment instead would be only worth $70,000—a difference of $79,345.



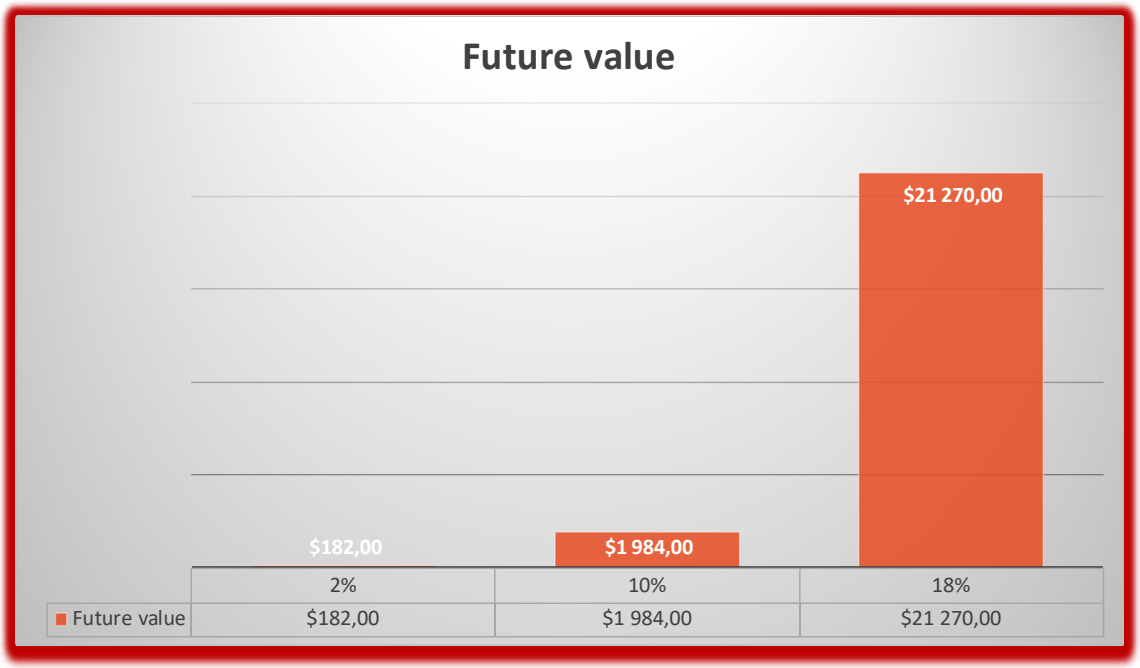
Yeah, you made money. You invested $10,000 and you got up to $70,000. You made $60,000. But what they made off of you, what Wall Street made off of you, was $79,345, and they didn't have to take any risk. You put the money in; you let them manage it, and they made the money under assets under management fees. They got your money with no risk at all to them because it didn't matter if you made money or not. You walked away from more than half of your return.

Really, the **power of compounding** is what this is. Let's take an example. So, $10 invested for 30 years. Simple interest versus compounded rates of return. Let's say that you had $10 at year one, and you took out $10 at year 30. At a 7 percent rate of return, you'd get $10 principal back. If you had invested without compounding, you would've made about 25 bucks, but with compounding, you end up walking away with $80 per $10 invested. That's the value of compounding.

Compounding is essentially a formula that allows you to reinvest that money on a monthly basis, and so you're making money off of the money that you already invested, and it generates a rate of return. You add that to your principal, so that you make more money off of it. If you don't have compounding interest, somebody else is eating your lunch.



Let's just do a little, quick comparison, just because I think it's important to understand what a huge difference compounding makes. Let's say that you took an investment at 2 percent versus 10 percent versus 18 percent over 30 years, and you invested $100. You start with $100. What is it worth at 2 percent, 10 percent, and 18 percent over 30 years? At 2 percent, it's worth $182. At 10 percent, your $100 has grown to $1,984, but at 18 percent over 30 years, your investment is now $21,000. That's a huge difference. This is going to become much more relevant shortly, when we start talking about what happens in the stock market and what your real rates of return are. I think you should pay attention to this, because your real rates of return are nowhere near what they're telling you.



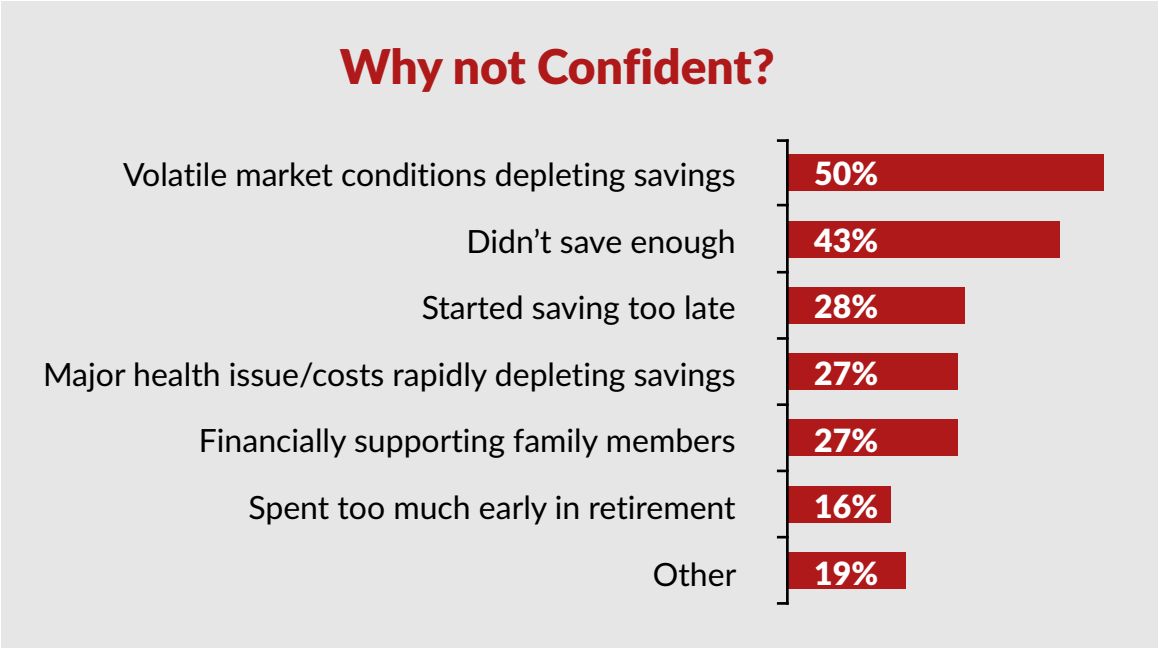
Quick analysis compounded returnRule of 72

Another way to look at it is the rule of 72. It's a quick way to determine the number of years it takes to double your actual cash. Now, this is a quick and dirty way. This is not science. This is just a real simple way -- back of the napkin. Take whatever interest rate it is. So, let's say you're going to make a 2.5 percent compounded return on something. Take 72, divide by 2.5, and it gives you the number of years it would have taken to double your money.

$$y = \frac{72}{r}$$

Retirement financial stability

Why is it that physicians don't feel comfortable about their financial preparedness going into retirement? This is an AMA study that was done in 2018, and over half the physicians are worried about volatile market conditions and depleted savings. 43 percent of the physicians felt like they didn't save enough. 28 percent thought that they started saving too late. If you look at all of these things, these physicians are heavily focused in on savings, and I'm going to conjecture that this is the wrong thing to do. Focusing in on purely savings is buying into the mentality of what portfolio managers want you to buy into, and I don't think that you can save yourself enough to get to retirement, based on market volatility, and inflation, and fees. Most people will never be able to retire, if you really look at it.



How much do I really need?

What do you really need? It's interesting. Most people think, «*When I retire, I'm going to spend less,*" and that's not really true. Most retirees actually end up spending more in the first few years in retirement, and it's probably because they have more time and they end up being able to go out and spend more money. Approximately 4 percent of your current global savings is the maximum that you can spend per year and still have money left and still get social security, assuming that it remains solvent and you don't have a disabling health crisis.

> So, if you had saved a million dollars, you could only get about $40,000 out a year and remain solvent through retirement. That's assuming that you're not sick, and that's assuming that you still get money from the social security program, which may or may not be solvent. That's assuming that the stock market has a steady rise, and it assumes that the inflation rate stays really low. Those are a lot of assumptions if you're invested in the stock market.

So, why not just invest passively in stocks?

I thought I'd do a little analysis for you. The average stock market return over the last 15 years was about 7.04 percent from 2004 to 2018, and it was a total of 9.06 percent for the last 30 years, 1989 to 2018. That means that if you invested $100,000 in 2004, it'd be worth $277,000 in 2018, and that doesn't seem like it's too bad, does it?

Let's do the math

Let's look at

- Volatility
- Brokerage fees
- Taxes
- Inflation
- Lack of leverage

The volatility of the stock market is that year over year, month over month, day over day, minute to minute affects the purchase and sale price, and due to your inability to actually time a market, the average return for $100,000 invested in 2004 would be worth $225,425 based on the actual annual returns of the S&P 500, **resulting instead of that 7 percent rate of return, it's really a 5.6 annualized return compounded.**

The brokerage fees and the average expense ratio for an actively managed fund is 0.5 percent and 1 percent, but they can be as high as 2.5 percent. Let's just say that you took out your 1 percent fee each year. Instead of being worth $225,425, your $100,000 invested 15 years ago is now worth $193,000, which is about a **4.5 percent rate of return.** This is not looking so good.

So let's say that if you're filing jointly, you make more than $77,000 a year, which you probably do. Your long-term capital gain rate is 15 percent. If you sold your entire portfolio, your **taxes** reduce your average **annual return from 4.5 percent to 4 percent.** This is starting to look dismal.

But then you've got this **inflation.** The federal reserve has an inflation target of 2 percent. It's mandated to have an inflation target of 2 percent. They're trying to do everything they can to maintain inflation of 2 percent. They haven't been very successful because the actual current rate of inflation is only about 1.6 percent. But if you compound that up over 15 years, an inflation rate of 1.6 percent reduces your **after-tax return from 4 percent down to 2.5 percent.**

The problem is, you really can't **leverage** the stock market. You can't go to the bank and say, «Hey, I want to borrow some money to invest in the stock market,» because they're going to look at you and say, «You're gambling. We don't invest in gamblers. We invest in hard assets. The stock market is gambling.» Maybe they know something that you don't know. Investing in the stock market is more akin to speculating or gambling–the odds are not in your favor.

So what does this mean?

All of this means that if you invested $100,000 in 2004, your actual return after you pay brokerage fees, taxes, and have your purchasing power eroded by inflation, you end up with a 2.5 percent compounded return.

Using the rule of 72, which is how many years does it take to double your cash, it would take 28.8 years to double your $100,000.

Now, let's just pretend that we have an inflationary period, just to compare. If your inflation goes up, you may actually be negative on your returns. There are assets that are inflation protected, and some of those assets are things like real estate. We're going to talk about that. With an 8 percent inflation-protected return in real estate, doing nothing else, it only takes nine years to double your money. Irrespective of the asset appreciation, irrespective of anything else, just the inflation protection gives you nine years to double, as opposed to 28.8 years.

Asset type, risk, return

So, everything when you look at risk, it's determined by the type of asset, the risk, and the return. All investments have some combination of type of asset, the risk and return, and so, what you're trying to really determine is what's its present value, what's its future value, and what's the risk in achieving that future value? Typically, if you're looking at assets and they're telling you they're going to give you an interest rate of X, Y, Z, typically in banking situations, the higher the interest rate that they're charging for a particular asset, the greater that particular risk factor has been designated. These are people way smarter than me and you.

If a banker tells you that they're going to charge you 18 percent on a credit card, but they're only going to charge you 5 percent on a house, they probably know that you're more likely to default on the credit card and less likely to default on the house. So, their money's protected. It's all a function of perceived risk. The problem is that physicians are not financially literate – they have financial illiteracy, they're brilliant in everything else, but they're financially illiterate. Because there's such a sea of marketing, they don't even know what they don't know. They're being manipulated by governmental policies. They're being manipulated into distorted economic decisions, and they're being manipulated by parasitic institutions that are using government policy and promulgating marketing to keep the physician from seeing the truth. The only way that you can get through this is to educate yourself, but if you don't educate yourself, you're going to fall prey to these predators.

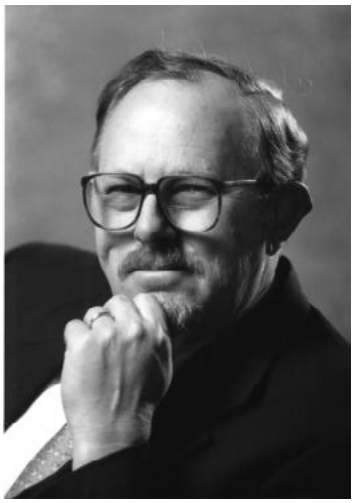
Risk adjusted return

Let’s talk a little bit about risk-adjusted return because I think it’s really important. I think that most physicians don’t understand what risk-adjusted return is.

- Why do we invest money?
- It’s to get a return. But is the return justified for the underlying risk? Because it’s not just, I’m going to give you 10 percent on your money.
- It’s, what’s the likelihood that I’m actually going to get 10 percent on my money? What’s my risk?

You have to be able to measure and analyze those returns. You have to be able to compare risks to the capital invested, and you have to be able to look across asset groups.

If I told you that a rate of return in a particular subsection of real estate versus another subsection of assets, like let's say stocks of Company Y, they both had same rates of return of 10 percent. But your risk ratio was much lower in real estate and your risk ratio was much higher in the stocks, which would be a better outcome? It's not just what the rate of return is, it's the likelihood of actually getting there.

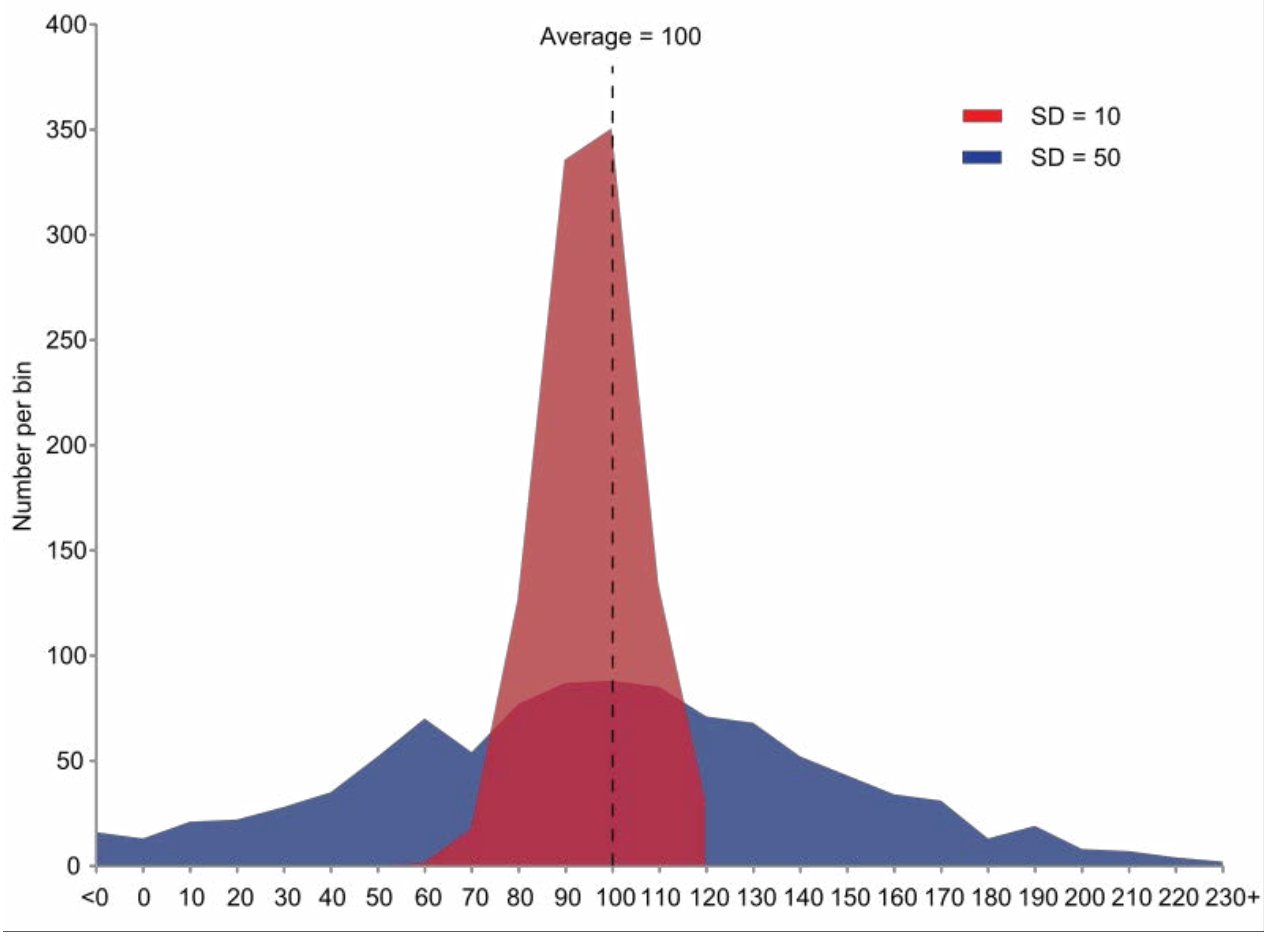


There's Doctor William F. Sharpe

He actually came up with this concept; he won the 1966 Nobel Prize. It really defines the average return earned in excess of a risk-free rate of return divided by the volatility. What this means is, I think I'm going to get $100 in this investment. But if I wasn't going to do this investment and I was going to invest in something risk-free, the closest we can get is governmental backed bonds. I was only going to make $90 on that, my net gain would be $10 over the bonds. But then I would divide that by the perception of risk. What's the likelihood that I'm actually going to get to there? What's that difference? What's that standard deviation?

That's really called a sigma, which is essentially, if you remember your days of statistics, it represents a standard deviation of a portfolio.

Here's an example: two different populations with the same mean. So, 10 percent or 100. Let's say that in this particular case it's an average mean of 100, but the blue population has a much greater standard deviation. So, it's possible that the blue population, you might be further along on one of the tails and may either have a very high income or a very low income. Whereas, the standard deviation for this red population is really narrow and it's unlikely that you're going to fall off of that population curve.



Risk adjusted return: Sharpe Index

So, the Sharpe Ratio exactly is the average rate of return of Portfolio A, minus the risk-free rate of return, divided by the standard deviation of the portfolio. You don't need to do this, but this is just what it is so that you have a good handle when somebody talks about risk-adjusted rates of return. You should understand that when they're talking about risk-adjusted rates of return, even though the return may be high, the risk is what they're not telling you about, and you have to understand that underlying risk.

$$S_A = \frac{\overline{R}_A - \overline{r_f}}{\delta_A}$$

S_A	Sharpe Ratio
$\overline{R}_A$	Average return for portfolio A
$\overline{r_f}$	Average risk-free rate of return
δ_A	Standard deviation of portfolio A returns

Risk is really in the eye of the beholder

If you can educate and if you can have granular decision making and you have hyper-locality in your decision making, you have a legal way to have an asymmetric risk-to-reward ratio. You can't do that in the stock market. If you have special knowledge of something in the stock market, that's actually a federal crime because if you know something that the average other person don't know, you're in trouble. You might be self-investing, or you might know the CEO of the company and he might have told you something – and you could end up spending the next 20 years in jail.

But in a lot of other asset groups, in a lot of other asset classes, if you have special knowledge, more power to you. I'll give you some examples of that.

Failure to account for the biggest loss of money: Taxes

So, taxes. You know the failure to account for taxes is incredible. Most physicians are either employees or they're self-employed. They have an average tax rate of 40-60 percent on their income. Doesn't that seem bizarre? Because these are the hardest working people we have in our community, and they're the ones saving the lives, and they're the ones that we're taxing the most.

You know who has the lowest tax rate? Investors and business owners – people that own dry cleaners, people that own convenience stores, people that invest their cash. In fact, if you make money on your money, you probably don't even pay any taxes at all. But if you're a hard-working physician and you get blood on your shoes and you have to deal with difficult patient situations that are life threatening, you're getting taxed 40-60 percent. It doesn't make a lot of sense. This is the issue. The biggest single cost burden that you have to your wealth is taxes, and you are in the wrong category, and so, you have to understand that and see exactly why.

40-60% tax rate	**0-20% tax rate**
Employees*	Business Owner (not professional services)
Self-employed*	Investors

What exactly are taxes?

I don't think taxes are good and I don't think that taxes are bad, and I know that it sounds stupid to even ask that question, so what are taxes? Think of it this way: taxes are a redistribution of wealth. They take money from people who have it and give it to people who don't, or they take money from place A to place B because we need B to have an incentive. Taxes are really incentives designed by federal, state, and local governments. The goal of these incentives is to create a specific policy.

So, for example, I could suddenly decide to start taxing tobacco, which we do because it discourages the use of tobacco. I could certainly start to tax carbohydrates, and it would have a huge impact because there would be less sugar-sweetened beverages in the market because the higher the taxes go up, the less likely there is utilization of X, Y, Z. So, taxes are an incentive. They're not a punitive thing. They're an incentive to do something different.

If you choose to ignore the social desires of your federal, state, and local government, just pay the taxes. That's all they're asking you to do. You've made a volitional choice; you're paying taxes. That's okay if that's what you want to do.

What's inflation?

Well, it's another kind of tax. It's a forced tax that is hidden. It's hidden because it's a frictional tax on supply and demand, and the government has to have a little bit of inflation. The government tries all that it can right now to have some inflation. Although in periods past, we were worried about hyperinflation, right now, we're worried about not enough inflation.

So, what are the alternatives to generate a higher rate of return but at a lower average risk?

That's what you should be thinking in your head. How do I make more money, but have lower risk? How do I have a better Sharpe Ratio? It's to invest in cash flowing, multi-tenant, commercial real estate. That's one of the lowest risk areas that we have.

In the last recession, this was the area that did really well. The stock market tanked. The single family residential tanked. But what really survived was multi-tenant facilities. Now, certainly there are changes that can occur. There can be changes in technology. There can be changes in economy. There can be changes in how people live and where they move. The thing is that all of those changes are demographic changes, and most of those demographic changes are predictable, 20, 30, 40 years out, because we can figure out what's going to happen.

That doesn't prevent some cataclysmic event from happening. It doesn't prevent something that is unknown to us – the unknown unknown. It does allow us to predict, though, and those demographic trends tend to be pretty accurate over time. So, let's go back to what I said: invest in cash flowing, multi-tenant, commercial real estate. It's cash flowing; it has to generate its own source of income. It doesn't rely on you. You're not putting money into it; it's putting money back to you. With multi-tenant, you're not beholden to one person or one entity. You've got lots of people, lots of entities, lots of things. With commercial, you can actually get a loan on it. You're not having to pay for it. Real estate is something that holds value and is an inflation hedge. If you put all of this together, this is a very low risk way to go with a higher than average rate of return.

Inflation protected

Multi-family investment is one of the things that we really do a lot of. These are really good, fantastic hedges against inflation.

Remember, the federal reserve says it wants an inflation target of about 2 percent. That means that everything goes up in cost, including rents. If you increased your rents, your income goes up, and yes, your expenses go up, but so does the value of your property. So, inflation protection is built into most multi-tenant, commercial real estate property. Everybody has to have a place to sleep and everybody has to have a place to live. So, for us, this is a sweet spot. This isn't the only one, but this is one that we particularly like.

Leverage:

stock investments vs. **real estate investments**

Just to give you a comparison on leverage, stock market versus real estate. When you buy a stock, you can only really buy it with the cash that you have. You could do some options and things of that nature. But the reality is, you're still buying something with the stuff that you have. Your bank is not going to lend you money to buy a stock position. That should tell you something right there. With real estate that's cash flowing, the bank typically lends you at 80 percent of the value of the real estate, and you get a five to one leverage ratio, which effectively accelerates your returns.

So, let's just say that you have a 2 percent change in net operating income. That would translate with that five to one leverage to a 10 percent change in leverage value. I'm going to go over net operating income shortly, but just keep that in mind. You're leveraging somebody else's money, and you're paying for it, obviously, but what you're paying them is way less than what you can possibly imagine.

Market intelligence is a unique type of leverage whereby you have something unique that you know about the conditions. It might be where you live; it might be something that you know about a future investment that's going to happen in your town. You're in the medical field; you might know where they're going to put a new hospital. You might know that there's a need for a surgery center. If you knew that and you invested in the stock market with that information, you would be in jail. If you know that and you're investing in real estate, you're just being smart.

I'll give you a classic example. I found out shortly before a federal grant was issued to a group of facilities that needed to expand that some of the locations that they were going to be looking at were available for sale, but they hadn't put the money down on them. So, I went out and I got options on all of these places and put down very cheap options to buy them. When these people ended up getting their federal grant, I was already ahead of them. I already had everything lined up, and I ended up essentially being far ahead of them, and they had to buy or lease from me. So, I had special knowledge, I knew about the federal grants that were coming out. I knew that there were only a few places that these guys could really invest in, and I got capitally ahead of them. I was then able to lease property to them, and that's a big deal.

Asset management fees

The average expense ratio for an actively managed mutual fund is between 0.5 to 1 percent. It can be as high as 2.5 percent. So, after you take out your 1 percent fee each year after a $100,000 investment over 15 years with a 4.5 percent rate of return, you lose about $30,000 just in asset management fees. That's a big deal.

The average expense ratio for a commercial real estate portfolio is about 1 percent, and it rarely exceeds 2 percent. What differentiates this fee is that the money coming to pay this fee comes from the tenants, not from you. The performance of the asset defines the rate of return for the real estate asset management. So, the real estate is also inherently sheltered from inflation, and the stock market is not. That combination could give you an extra three or four percent yield.

Rule of 72

Those three or four percent has a huge impact on your rule of 72. Remember, the rule of 72 is 72 divided by the interest rate equals number of years to double money. Play with this for a second. What is it worth to you to have a 2 percent interest rate, a 10 percent interest rate or an 18 percent interest rate? How many years does it take for you to double your money? I think it's really important that you physically look through this.

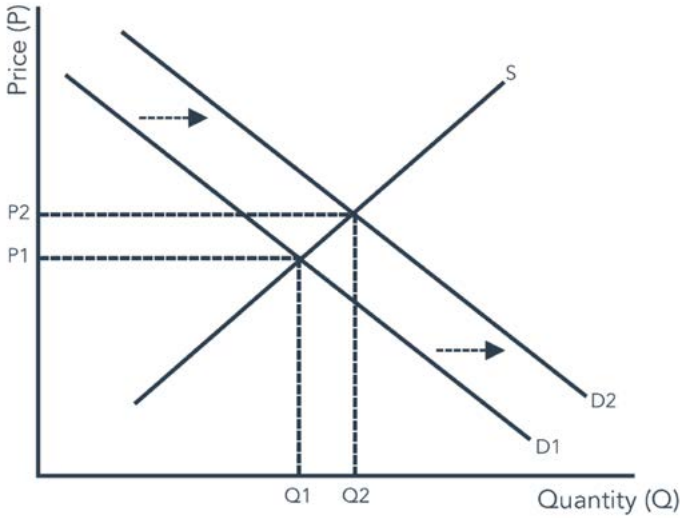
$$\frac{72}{X\%} = \textit{years to double money}$$

Demographics determines Demand. Demand determines Price.

I'm going to throw something at you. Demographics is what happens to populations, and populations determine value. The more people that want a particular thing, the higher the price. The less people that want that particular thing, the lower the price. In real estate, supply of real estate and utilization of real estate is fixed, as in terms of land. Certainly, you can increase the supply of real estate by building, but what is easier to change is demographics – the number of people coming into a community.

So, if you have a bunch of people coming into the community, you're shifting your demand curve from D1 to D2. If you have people coming in and your supply is remaining linear, then what ends up happening is your price has to go up. But let's say that instead, you're in a community that is at D2 and you're losing population. Your price is going to go down, and your supply is essentially the same. So, demographics are incredibly sensitive indicators as in terms of what happens to price.

I look at demographics as a headwind or a tailwind. If you're flying a plane and you're going 500 miles per hour and you have a 200 mile per hour headwind, you're going to take longer to get there because your net weight is 300, or you're going to burn more energy to get there. But if you're flying that plane and you have a 200 mile per hour tailwind, you're going to get there a lot faster or you're going to have a lot less energy burnt to get to the same place. It's almost the exact same thing. **Demographics are headwinds and tailwinds in the economics of the issue of price and demand.**

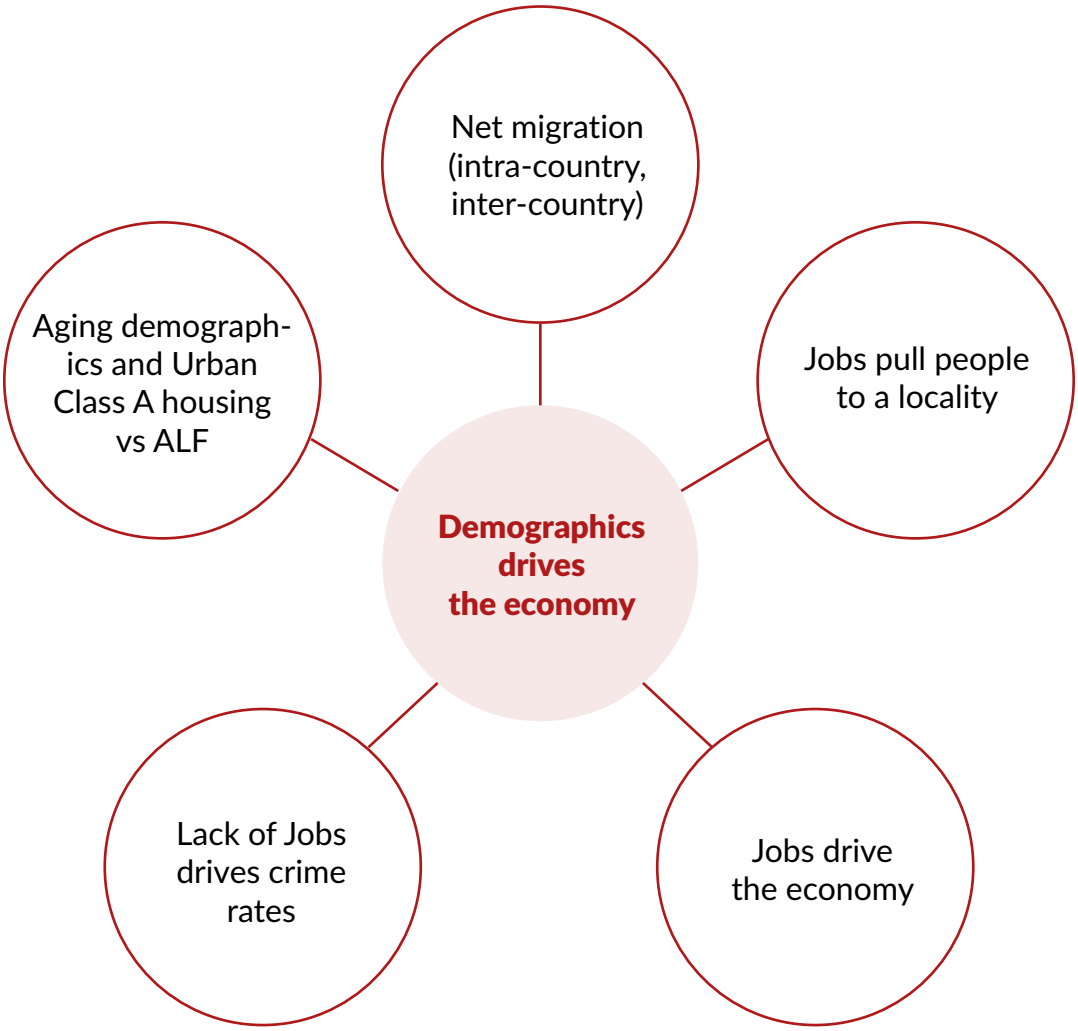


Demographics drive the economy

It's all based off of population statistics, so there are a couple of things that you should be aware of. America's birthrate is really low, and we have not been producing enough babies for the generations to replace themselves. We have to have a steady influx of people coming into the country, because if we don't, we're not going to have enough people to maintain our demand levels. If our demand levels start to drop, our prices are going to start to drop. Certainly, I know that **real estate is a fixed total supply, but the reality is if your demand drops in a fixed total supply, your price goes down, and so it's just something that we have to be aware of.** Now there are other factors, and part of those factors are as that population ages, they live longer. So the demand may go up as an aging population goes up. But, we have to be very careful what economics they have, and what they're willing to buy and not buy, so I use the demographics to help predict what happens to price and supply in a particular asset class.

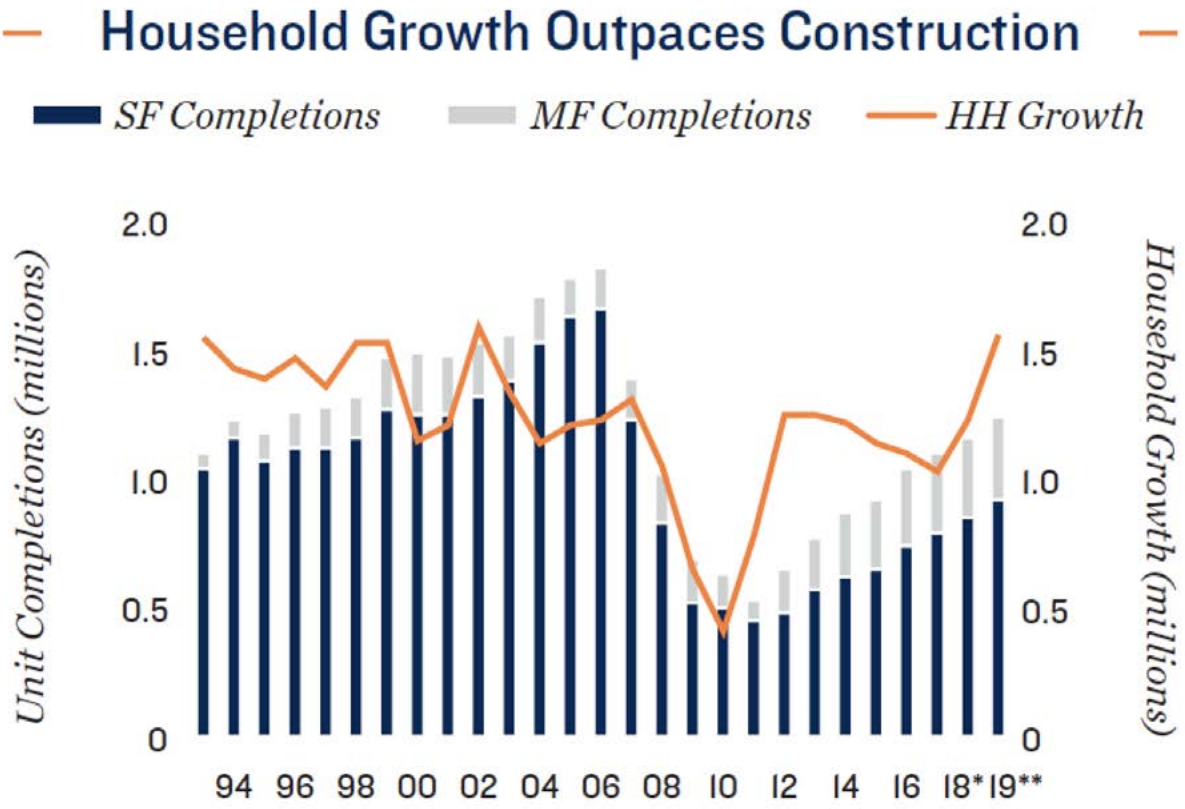
It's a combination of net migration, intra-country and inter-country. So let's say that I'm going to buy something in an area that's losing population quickly. I'll give you an example: Detroit. Detroit continues to lose population. No matter what you do, your population is leaving, so you have headwinds there. You're not going to be able to increase price over time, because you don't have the demand and your population is leaving. Whereas, let's say you compare that to Orlando or Tampa where a lot of people are moving in no matter what. That same real estate, that same asset that's at that location, is going to have a higher demand, and there's not more of it, so the price goes up.

Jobs pull people to a locality. People don't move to a locality because they want to move there. The vast majority of people move to a locality because they're able to work. Jobs drive the economy, and a lack of jobs drives crime rate. This combination of stuff poses some interesting thoughts on what the future of real estate investing is – assisted living facilities, skilled nursing facilities. What happens to the millennials? What happens to retirement? There's a whole host of things that I'll be discussing in other modules that we'll look more closely at, just that demographics. This is really meant to be an overview.



As you get more new households formed, then rental demand goes up, and the thing is that the vast majority of household formation, new people coming into households, they're really looking for B and C quality property. But the only thing we're building is A quality property, because it's almost impossible to build B or C. It's too expensive, and so B and C properties actually have reduced production and high demand, and A properties have high production and reduced demand. What do you think is going to happen to the price on these things?

This is just a simple display of household demand, household growth, and what's happening over time. Household formation is far exceeding the completion rate of multifamilies, and if you look at it a little bit closer, you're going to find out that the multifamily completion is in class A facilities, but the vast majority of household formation is B and C.



Risk and reward: the greater the risk, the greater the opportunity for reward.

In real estate, one of the most important things that you can figure out is how do you define what something is worth? I think that this is one of the most important formulas in real estate, so I'm going to spend a few minutes on it. It is essentially net operating income divided by the value equals the cap rate. So, the cap rate is inherent and specific to different asset types, different locations, and different quality of asset – whether it's an A, B, or C type location, whether it's a major metropolitan area, whether it's rural. What is the asset? Is it an industrial building? Is it a farmhouse? Is it a farm rental land? Is it a multi-family apartment unit? So, there's an inherent cap rate that we measure one asset against another. This is a different way to look at risk adjusted reward and having a generalized principle, and we do that through cap rate.

So, if something has a 10 cap, or a 10 percent cap rate, that's going to have a different value than something that has a five cap. Let's kind of go over that. Net operating income is equal to income minus expenses. So, you take all of the income, you take all the expenses away, and that's what you're left with. For example, if an investment property has $50,000 of net income before you look at any debt service, you have $50,000 of net income, and its value in the market is a million dollars. That means that its inherent cap rate is 5 percent.

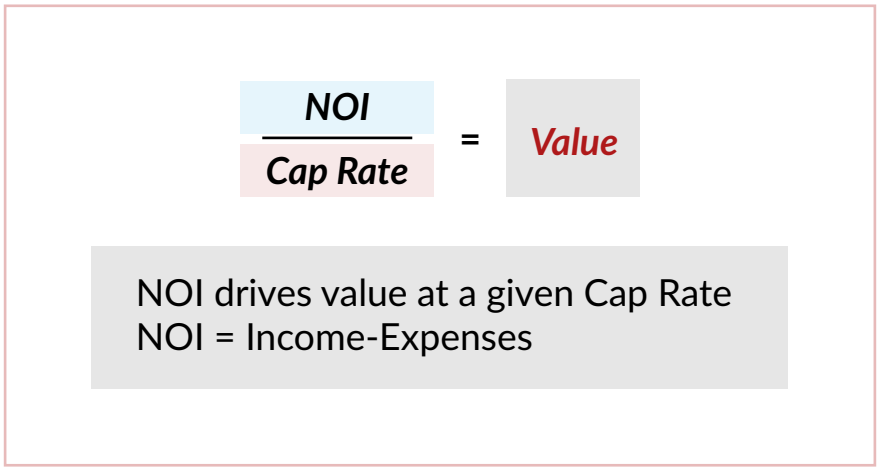
$$\textit{Cap Rate} = \frac{\textit{NOI}}{\textit{Value}}$$

But now let's take a look at it a different way. Let's play with the formula. Let's say that I want to figure out what the value would be if I changed my net operating income. What would be the value? What would be the value in a different market if my net operating income was higher, but I was able to buy it for the same amount of money? So, let's take that example. Let's say that I went to a different market and the thing was generating $80,000 as opposed to $50,000. But I was only having to pay a million dollars in both situations. The value's the same. But one cap rate, the first one where I was generating $50,000, is a cap rate of 5 percent. Where I'm generating $80,000 of net operating income, my cap rate is now 8 percent. That's a 3 percent difference in cap rate, and that can be very substantial.

It can tell you a lot about the demographics. The higher the cap rate, the higher the perceived risk for that asset group by people that are far smarter than you and I. It's a summary total. It's people that have already invested in this kind of asset class in this kind of city, and they've kind of sat down and said, «Hey, this is what I am willing to pay.» «Well, this is what I'm willing to pay.» You and I have probably done a few real estate transactions, but this is the summarization of tens and 20 and 50,000 real estate transactions of that asset group, of that asset type in that community with that demographic.

So, the cap rate is an easy way to compare between different rates of return, and it also can have the formula manipulated so that if you know the cap rate and you change the net operating income, you haven't changed the property, so it's the same property. The cap rate stays the same, but if you change your net operating income, what happens to the value?

Here we have net operating income divide by cap rate. So, assuming same property, same location, but a change in that operating income. What happens to value? I think that this is the single most important thing in commercial real estate. If you get nothing out of my entire presentation, realize that this is how we value things. The actual formula, the forward formula, is cap rate equals net operating income divide by value. But if you flip it and you do value equals net operating income over cap rate, assuming it's the same property, that provides you tremendous additional information.



Given a Cap Rate of 5%

Let's say that you know what the cap rate is for the area for this kind of property. It's about 5 percent. You know what the net operating income is, it's $100,000. So, what's the value of that property? Well, if you pay more than two million dollars, you're an idiot because based upon cap rate, it should be two million dollars. Now, that's what it should be. There are some manipulations that you can do to that, but that's in essence assuming all things equal, a five cap with $100,000 of net operating income should give you a translated value of two million dollars.

$$Value = \frac{NOI}{Cap\ Rate}$$

$$Value = 100{,}000 / 0.05$$

Δ NOI and Δ Value

But let's say that you change your net operating income slightly -- $10 per unit, per month, for 100 units. So, you go up $10, which doesn't seem like a lot. You do it for 100 units, though, and there's 12 months in a year. So, you get $12,000 increase in your net operating income. On that five cap, you changed your value by $240,000, which is a very significant portion of your purchase price. So, a small subtle change creates a huge leverage effect on value.

$$\Delta Value = \frac{\Delta NOI}{Cap\ Rate}$$

$$\Delta Value = 12{,}000 / 0.05$$
$$\Delta Value = \$240{,}000$$

Leverage reduces risk in RE but increases risk in paper assets

That brings me to the concept of leverage. Leverage reduces the risk in real estate, but increases the risk in paper assets. You can't really leverage paper assets, per se, because you have to pay for them. The bank doesn't give you a loan on them. You can use leverage to generate asymmetric return. So, if you're buying an asset that you're leveraging and you're able to get a loan on it, that means that the bank thinks that it's a pretty good investment because they know they're going to get their money because they're not going to loan you money unless they know they're going to get their money back.

Leverage acts as a risk buffer because your eyes are on that project and so are the bank's and so are everybody else's. As you buffer the risk by getting bigger and safer properties, you can get professional maintenance and management. The interesting thing is that you're a passive investor in these big projects, so these are usually isolated risks. You're not at risk for any of the losses per se, more than the money that you invested. That's true in the stock market as well. You're only at risk for your total amount of investment, unless you've purchased a put or a call.

But the thing is that no one can go after you to make you go more. If you own a house and you own it directly and you've gotten a direct bank loan on it or you own a four unit and you've gotten it directly and the thing burns to the ground and you didn't have insurance, you're on the hook for the whole amount to the bank. Whereas, if you're a passive investor, you're protected from this. So, you have all the upside and none of the downside really.

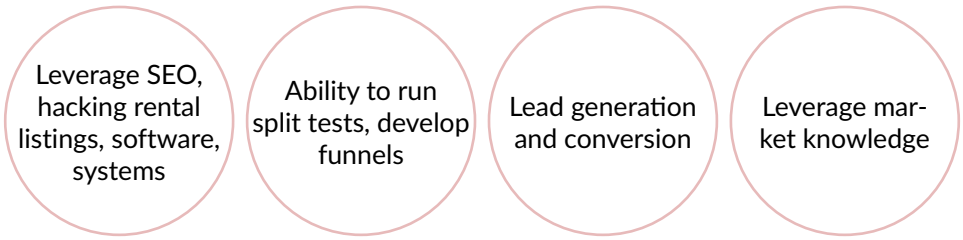
You can leverage other people's money – your tenant's money

Not only are you leveraging the debt from the bank, the tenant is paying down your loan. You're using their money to pay off the loan. You're not spending your money that you earned as a physician to pay off the loan. You're using the tenant's money.

You can leverage technology. You're way more computer savvy than most other people, so you're going to be able to leverage some of that technology and understand that technology. But you can also leverage experts who are way smarter than you and have them help you with technology, and the whole thing in commercial real estate is who wants to rent from you.

So, if you have a larger demographic of people that want to rent from you, your prices can be higher. If you don't leverage technology, which most people don't do, your prices are lower.

Leverage technology



When you leverage debt in a real estate deal, you create a five to one ratio of growth. So, let's say that you personally decided that you were going to buy a $100,000 property, versus you took $100,000 and you invested it into a $500,000 property that you now controlled, and both of them generated a 10 percent growth.

Your $100,000 property becomes $110,000 in self-owned un-leveraged property. Your $100,000 in a $500,000 controlled property that you've got debt on becomes $150,000 as a passive, less the interest rate of 5 percent that you're going to end up paying on $400,000, which works out to $20,000, leaving you a net of $130,000. So, you still make $20,000 more leveraged than you did un-leveraged, and you've got the risk protection and you've got the tax advantage as a passive investor.

Leverage OPT

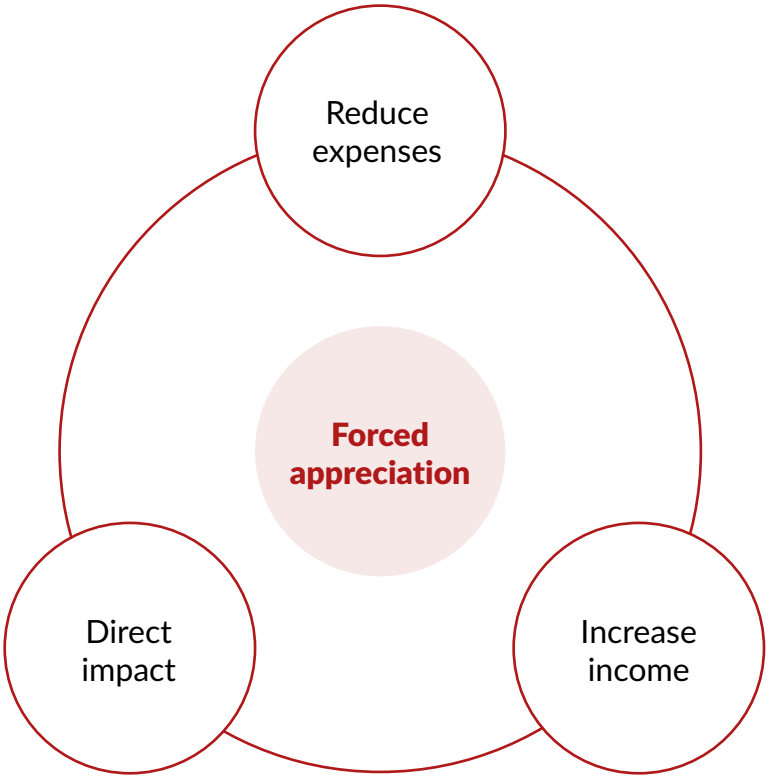
So, the most important thing that we have in the world is time. We have to be able to leverage other people's time because that's the one non-renewable resource. We can make a lot of money and we can make it again and we can make it again. But the one thing that we can never do is make more time. So, more valuable than money is time. If you have money, you can buy other people's time to do the things that you need to do. You can leverage relationships; you can leverage your asset protection attorney. You can leverage your accountant. You can leverage a virtual assistant. You can leverage all kinds of other things, all kinds of services and all kinds of other people's time to make you have more time.

You’ve got to be able to leverage economies of scale

The bigger the project is, the much lower the risk. I'll give you an example. Let's say that you owned one unit and only one unit and it became a vacant unit. Well, one unit unoccupied is 100 percent vacancy. There's no income to pay any bills. Let's say that you own 50 units and five of the units are now vacant. You're still 90 percent occupied. That's a 10 percent vacancy rate. What's happened is you can still pay all of your bills and you can spend the time it takes to get the tank refilled. **So, economies of scale reduce your risks. They don't increase your risk.**

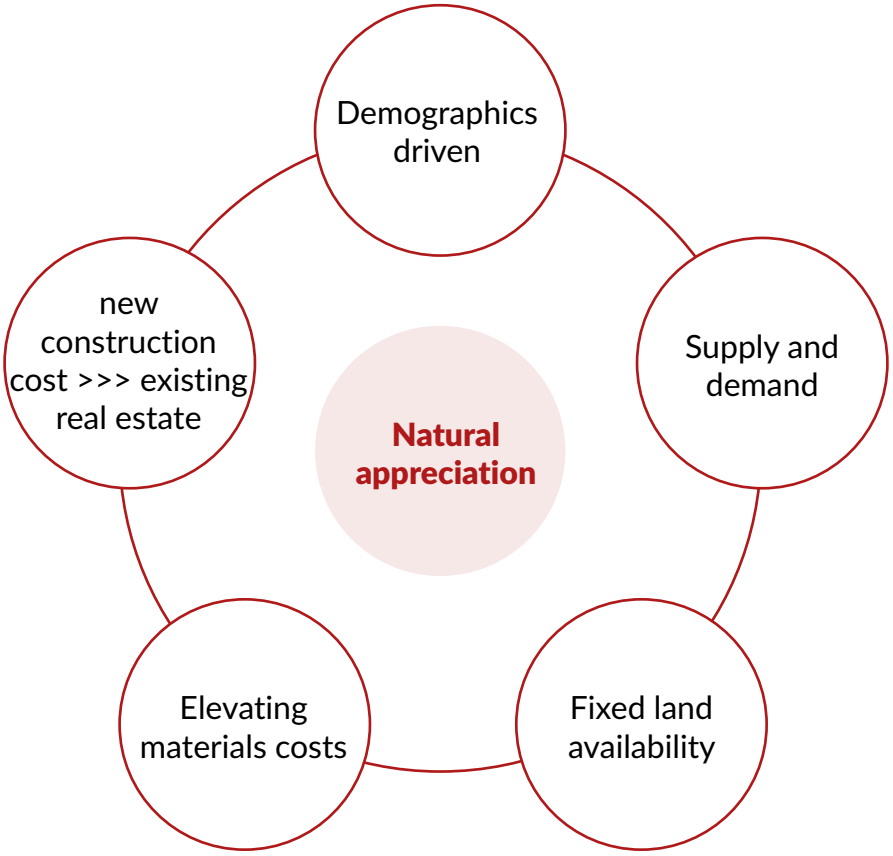
You get forced appreciation

Over time, the property that you have with inflation goes up anyway. That's passive appreciation. But forced appreciation is you can look at these expenses and you can look at the income, and you can increase the income slightly. You can do things like put in pet fees. You could put in parking fees; you can add a laundry service. You can put in valet trash services. You can do a whole host of other little subtle things to cause an increase in income. You could slightly enhance the units, or you could do things that reduce your expenses. For example, you could change how your utilities are billed. You could do a shared billing of utilities and force some of those expenses back to the tenants. All of these things create forced appreciation because they change your net operating income. If you change your net operating income, given the same cap rate, you have a tremendous increase in value, and this is a direct forced appreciation.



There's also natural appreciation, which is demographic driven

It's supply and demand because there's just no more land that we're going to be making. It's interesting – material costs seem to keep going up, and as material costs keep going up, cost of new construction is higher. If the new construction cost is far greater than existing construction, then it's going to force the price of the existing assets to go up. That's just the reality of supply and demand.



The thing is, you can leverage confidential information in real estate that you could never leverage in the stock market. You could look at meetings with politicians and figure out what their plans are for that city for the next five years. This is all available information and it's not inappropriate to use. If you did the same information meeting with the CEO of a company and you invested in his stock, you and he would both go to jail.

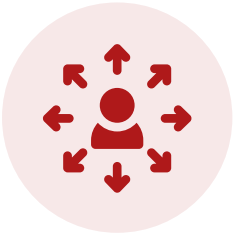
Tax benefits (informational, not tax advice)

So, I'm going to give you some just general tax information, and this is specifically not meant to be tax advice. This is for informational purposes only. In general, in real estate elements, everything has a useful life, and the federal government recognizes that. In general, most useful life for commercial real estate assets is about 31 years, and for residential it's about 27.5 years. So, they figure that they'll let you write off that amount of the real estate during that revenue cycle, during that period of time.

So, you take one 31st of commercial real estate and write it off every year. You can do one 27.5 ... one 27th of residential real estate and write it off that year. But what they won't let you write off is land because land is never depreciated. Land is fixed. So, there are some interesting things that we can do in real estate though that most people can't do. We can do cost segregation studies. We can break up a piece of real estate and say, «Hey, this portion of the real estate may wear out faster than that portion.» Even though we haven't replaced it, we get to depreciate it quicker.

So, some of the plumbing may be depreciated quicker, or the hot water heater may be depreciated quicker. The paint may be depreciated quicker. The carpet might depreciate quicker. There are a whole bunch of different depreciation schedules if we do a cost segregation study to figure that out. Recently, in the most recent tax changes, there was something called bonus depreciation that got kicked in, so that allows you to depreciate even more.

Now, depreciation is really valuable because you can use depreciation, which is a passive loss. You haven't actually lost any money; it's just a passive loss, and you can apply it to a passive gain and not pay taxes on it. Now, if you're in the real estate business, you might be considered full-time, or at least more than 50 percent, and instead of it being passive, it can be active. There are families where the husband or wife doesn't work and the other one does, and they're physician couples. So, the individual who's not the physician becomes a professional real estate investor and uses their active losses against the active gains of their husband or wife, and they end up paying no taxes whatsoever.



There are also tax benefits in things called **opportunity zones,** which I really can't get into here. But there are also tremendous tax benefits as a passive investor investing in real estate as a TIC, tenants in common if you're rolling over a 1031. So, let's say that you're rolling over a piece of real estate and you're selling it, but you don't want to pay the taxes on it. We have ways that we can help you with this in terms of getting a tenants in common, and I'll probably do just an entire section just on tenants in common.

Retirement plan participation and avoiding 35% UBIT taxes

Let's say that you decided to invest in real estate through your retirement account. First of all, you couldn't have a standard mutual fund retirement account. You'd have to go to a specialized self-directed IRA. But let's say that you did that. You have to keep in mind that most IRAs, if it's a levered piece of real estate, which it almost always is because you're buying it with bank money, you're going to pay 35 percent of the money on UBIT taxes. There are ways to avoid that, and we'll talk about that in another section. UBIT is unrelated business income tax that gets triggered if there's any debt on the investment that your IRA has made. **So, it's really important that if you're using IRA money that you're aware of this, that you risk 35 percent of your gains. There are ways to avoid that, but you have to pre-plan for that.**

- Who are the smartest people in the room if you're comparing yourself to the dry cleaner or you're comparing yourself to the car mechanic?
- You know, it's really a function of what did you do with your money?
- What did you do with your time, and what did your money do for you? If your money has already retired, if it's doing nothing for you, then it's not working nearly as hard as you want. Your money should be working harder.

The reality is that you've already won the money, but you're losing the time game. You have a high income, so you're 90 percent of the way there. If you just do a few things right, you can be incredibly financially successful. You can leave a legacy and you can leverage other people's time with your money and be incredibly successful at a much lower risk and a much higher reward.

We search for value-added real estate for our passive commercial real estate partners, and we actively manage that investment long-term for a successful exit. We are Red Pill Kapital. Find us at **redpillk.com.**