OCTOBER 2004 BANK NOTES, R. Nelson Nash, Editor

BECOMING YOUR OWN BANKER is four years old this month and has sold over 65,000 copies! Not bad for a self-published book that is not available in stores. Its primary means of distribution has been through life insurance agents who purchase them in quantity and get copies in the hands of their clients and prospects.

BYOB is now available in audio book! Two CDs -- almost two hours in total length. It has been re-written for audio format and is read by a professional radio voice of a prominent radio station in Birmingham, AL. You can purchase it on www.infinitebanking.info or just e-mail me at Nelson31@charter.net. I keep a supply on hand for such orders. For those who don't like to read, this is the answer!

LAST QUARTER I TOLD YOU ABOUT A Power Point Presentation that David Stearns, Chief Operating Officer of Infinite Banking Concepts, was developing. It is now complete and is available to life insurance agents only. It is 45 to 50 minutes in length and is a perfect introduction to the concept for clients and prospects. You can contact David at David_Stearns@charter.net.

Here are some important articles that you will find valuable. Enjoy!

Pension Pain: The Other Social Insurance Crisis

by Carl F. Horowitz

Private pensions in this country date back more than 100 years, that is to say, to a time when most people didn't live long enough to collect them. Nowadays Americans take living comfortably to 75 and beyond to be an entitlement. Not that longevity in itself is something to complain about, but it does have a few downsides—like a gradually sinking pension system.

Pension Benefit Guaranty Corporation (PBGC) is a federal agency whose responsibility is to protect current and future retirees—as of now about 44 million—in the event of a meltdown of their employer-sponsored pension plan. The Washington, D.C.-based entity was chartered as part of the Employee Retirement Income Security Act of 1974 (ERISA).

Congress intended PBGC to insure traditional, or "defined-benefit," plans. Under such a plan, an employer or employee representative (e.g., labor union) makes periodic contributions to an investment fund whose managers promise to pay all participating workers their vested benefits upon retirement or departure. The worker's benefit

level is determined by a formula based on earnings and length of service. Benefits are paid as a monthly stream of income, known as an "annuity," or as a lump sum.

It's a fact of life that pension funds can and do fail. Indeed, the collapse of Studebaker a decade earlier, more than any one event, led to the ERISA law. When that auto manufacturer shut down its assembly plant in South Bend, Ind. in 1964, only 3,600 of 10,500 workers and retirees—those aged 60 or older who had put in at least 10 years of service—received their promised benefits. Some 4,000 others, aged 40–59, received only 15 percent, while 2,900 remaining persons under age 40, got nothing. In creating PBGC, lawmakers were confident that no employee would ever get burned like this again. As the law stipulated that a pension plan's assets must be sufficient to cover liabilities, intervention by the corporation would be a last resort.

Looking Great on Paper .

Pension Benefit Guaranty Corp., on paper anyway, is a purely self-financing edifice with sturdy firewalls against failure. As an insurance agency, it derives much of its income through premiums—around $800 million annually in recent years. It also invests in financial markets, especially fixed-income funds, and the result has been the buildup of a trust fund now worth $35 billion. PBGC receives no tax dollars and is not backed by the full faith and credit of the U.S. government. There also is an adjustable per-worker ceiling on claims payouts. The maximum guaranteed annual pension at age 65 for participants in plans terminating in 2003 was $43,977, lower for those who retire earlier or elect to receive survivor benefits. Certain early retirement subsidies and benefit increases made within the most recent five-year period may not be fully guaranteed.

Perhaps the most important safeguard of all is that PBGC does *not* step in whenever an employer pulls the plug on a sound plan. The vast majority of defined-benefit plan terminations are precautionary measures rather than reactions to actual or pending bankruptcies. In such instances—and there have been more than 160,000 of them since ERISA's passage—assets are sufficient to cover accrued liabilities. .

It's when plans are chronically and severely troubled that PBGC enters the picture. When an employer goes bankrupt or otherwise cannot make good on its pension promises, the agency takes over the plan, in some cases going to court to get a termination order. At that point, PBGC covers all outstanding pension liabilities, provided the employer meets at least one of four ERISA-defined distress tests.

Two examples of a PBGC takeover, both from this March, illustrate the extent to which pension funds often fall short of delivering on their promises. The Columbus, Ga.-based Johnston Industries, a maker of household and industrial fabrics, had two plans collectively funded at only 40 percent, with $23 million in assets covering $58 million in promised benefits (i.e., liabilities). And Top-Flite Golf Co., a Chickopee, Mass.-based manufacturer of golf balls, was only a little better off, with $26 million in assets covering $56 million in liabilities. .

The 800-member staff of Pension Benefit Guaranty Corp. is finding itself busy these days handling such hard cases. In 2003 the agency reimbursed plans to the tune of $2.5 billion, a figure representing roughly 1 million workers and retirees in about 3,200 terminated defined-benefit plans. Agency officials expect claims payments to rise to $3 billion this year. Granted, that's still a small portion of the total $1.5 trillion

worth of liabilities that PBGC currently insures, but the real story is that many plans not taken over (yet) are dangerously, and deceptively, underfunded. And because of that, a sharp economic downturn could be a calamity, not simply a problem. .

Insured single-company plans by the end of 2003 had amassed a cumulative deficit of about $350 billion, down somewhat from the $400 billion figure from a year earlier, but still way up from the $50 billion-to-$100 billion range of the 90s. PBGC, for its part, seems less than prepared to handle a deluge of fund collapses. During FY 2002 the agency's balance sheet went from a $7.7 billion surplus to a $3.6 billion deficit, a loss of $11.3 billion, more than five times larger than any previous one-year loss. The deficit since has slid further (as of March 31, 2004) to $9.7 billion. .

Sources of System Instability

There are four key explanations as to why a seemingly healthy insurance system suddenly has entered such precarious straits.

First, during the 1980s employers began to discard the defined-benefit in favor of the "defined-contribution" approach, prime examples of the latter being 401(k), 403(b) and Keogh plans. Under a defined-contribution plan, the participating employee, within prescribed employer-sponsored limits (and occasionally with matching employer contributions), makes the decisions as to where and how much to invest retirement funds. The employee, by virtue of this, bears all the risks. These plans exist outside the federal pension insurance system.

The switch was an adaptation to some emerging realities: 1) contributions to defined-contribution plans are tax-deductible; 2) the long-stagnant stock market had begun a long swing upward starting in 1982; and 3) the habit of lifelong loyalty to a single company was yielding to a view of career planning that allowed for, and to an extent encouraged, changing jobs several times, and with it a greater incentive to insist on plan portability.

Labor Department data reveal the extent to which defined-benefit plans have fallen out of favor. Whereas 39 percent of all U.S. workers in 1980 were covered by a traditional plan, this figure less than two decades later had dropped to 22 percent—and a good two-thirds of the latter had consisted of defined-benefit/defined-contribution hybrid plans. The shift in the share of defined-contribution participants was nearly the reverse, rising from 8 percent to 27 percent. (A little over half of all workers in either case lacked any retirement plan).

From its 1985 peak of 114,400, the number of defined-benefit plans in force has shrunk to its current level of around 31,000. One result of all these terminations has been PBGC's loss of potential income from premiums. Another consequence is a "creaming" effect. Because companies voluntarily leaving the system tend to be the most solvent, the ones remaining are those posing the greatest risks.

A second reason for underfunding has been the double-whammy in the stock and bond markets for much of this decade. A sharp decline in stock prices during 2000–02 diminished the assets of company pensions and the PBGC alike. Over the course of the 1980s, according to Ibbotson Associates, annual real equity returns averaged 11.9 percent, rising to 14.8 percent during the 90s.

By contrast, during the 2000s (through August 2003) equities incurred an annual average *loss* of 10.8 percent. Meanwhile, low bond interest rates inadvertently have raised funding requirements. In a pension plan, liabilities are calculated by adding up the value of promised future benefits and then discounting that sum to obtain a present value. For years, plan sponsors reluctantly have had their liabilities tied to 30-year U.S. Treasury bonds, which offer interest rates about as low as possible. Using these rates as the basis for a formula inadvertently had inflated liabilities, thus heightening the appearance of plan underfunding and triggering higher funding requirements. That the government stopped issuing new 30-year Treasuries in 2001 only added to the demand for those remaining in circulation, further driving up prices and driving down interest rates.

Third, the ERISA law enables companies with chronically underfunded plans to receive an implicit subsidy from companies with sound plans. When a company gives employees a pay raise, it pays for the raise immediately. But when the company hikes the employees' pension, it can defer the cost for up to 30 years. Deferral is an especially attractive strategy for companies short on assets—in other words, for the ones that aren't doing well in the first place. Since PBGC is legally obligated to make timely payments on all promised benefits, this increases the pressure to raise premiums on everyone else.

And annual premiums have gone up. In the original legislation Congress set the rate at a mere $1 per worker, so as to encourage maximum participation. Lawmakers in 1987 raised that to $19, adding a variable-rate premium of 0.9 percent of a plan's underfunded sum to be measured on a "current-liability" rather than a "termination" basis.

A highly unsound plan can avoid this surcharge by showing (in most cases) that it is 90 percent or more fully funded on a current-liability basis. That's why Bethlehem Steel, whose $3.9 billion claim was the largest in PBGC history, paid no variable-rate premiums in the five years prior to termination (the firm declared bankruptcy in October 2001). In its last filing prior to termination, the company was 84 percent-funded on a current liability basis, but only 45 percent-funded on a termination basis.

It is little surprise, then, that many companies with sound pension plans, already paying higher premiums because of the bad apples in the system, are either freezing or terminating their plans. Why contribute to them when severely underfunded plan operators can get away with paying the same premium? The situation is analogous to one in which safe drivers, already resentful over having to pay higher premiums to cover claims created by accident-prone drivers, discover that the high-risk drivers pay no more!

Fourth and finally, organized labor has exerted a major influence in getting private-sector employers (though not to the extent that they've corralled employers in the public sector) to retain pensions and raise contributions. According to the U.S. Bureau of Labor Statistics' National Compensation Survey, 74 percent of all unionized private-sector workers in 2003 participated in a defined-benefit plan, as opposed to 15 percent of their nonunion counterparts.

This huge difference is no coincidence. Labor officials generally disdain defined-contribution plans as an attempt by employers to weasel out of their commitments,

shifting risks to individual workers. The AFL-CIO's Web site describes defined-benefit plans as "real pensions." The problem is that union intransigence has created some real problems. The pension woes at the Big Three automakers, for example, can be traced back to the United Auto Workers' success a few decades ago in winning ample pension concessions, and fending off company efforts to curb such spending.

The legacy of such union activism is being felt today. Last October GM announced it had diverted an extra $13.5 billion toward its employee pension funds, with another $6 billion likely soon to follow. Maintaining high-cost pension plans show up in production costs, and ultimately showroom sticker prices. A recent article in the *Detroit Free Press* reported that pension, retiree health and other benefits cumulatively account, on average, for $1,360 of every GM vehicle rolling off the assembly line. The respective figures for Ford and Chrysler are $734 and $631. By contrast, the per-vehicle benefit cost for Honda and Toyota vehicles assembled at U.S. plants amount to a scant $107 and $180, respectively.

As much as private-sector unions have an inherently adversarial relationship with employers, both have been partners in pushing pension liabilities as far into the future as possible. This is especially true for employers faced with the unpleasant choice of downsizing or bankruptcy. On the asset side as well, unions often stand with management. They view stocks as better investments than bonds, as stocks over the long run are likely to produce larger returns. The downside, as the unions and everyone else discovered during the two and a half years starting in March 2000, is that the stock market is an escalator that can go down—way down—as well as up.

Remedial Action: Symbol or Substance?

PBGC officials are the first to admit to the system's structural flaws. The agency's then-executive director, Steven A. Kandarian, offered the following summary in prepared testimony before the U.S. Senate Special Committee on Aging in October 2003:

Pension insurance creates moral hazard, tempting management and labor at financially troubled companies to make promises that they cannot or will not fund. . . . In exchange for smaller wage increases today, companies often offer more generous pension benefits tomorrow, knowing that if the company fails the plan will be handed over to PBGC. These companies are using their pension plans to unfairly shift their labor costs to responsible companies and their workers. At some point, these financially strong companies may exit the defined benefit system, leaving only those companies that pose the greatest risk of claims.

To set PBGC on the right track, Congress recently passed temporary two-year legislation, the Pension Funding Equity Act, which President Bush signed into law this April. The law's key feature, worth about $80 billion, would switch the basis for calculating pension plan liabilities from ostensibly risk-free, 30-year Treasury bonds to long-term, high-yield corporate bonds. Employers, seeking to reduce levels of mandatory contributions, had been clamoring for this. Call it what one will, but this provision is a loan by any other name. Employers, in effect, will be borrowing from their pensioners. And in the event their pension plans default, taxpayers ultimately will be liable.

The law also provides $1.6 billion in special relief to the airline and steel sectors by waiving special funding requirements normally imposed upon troubled pension plans. These two industries accounted for nearly three-fourths of the dollar value of all claims paid out during FY 1975–2002. Early in the 90s PBGC found itself having to manage the pension plans of the bankrupt Eastern and Pan American Airlines, with respective liabilities of $600 million and $800 million. Those sums seem modest in comparison to the plan liabilities PBGC has inherited from steel-industry bankruptcies: National Steel ($1.3 billion), LTV Steel ($1.9 billion), and Bethlehem Steel ($3.9 billion). One dreads what would happen if the auto manufacturers went this route.

Many companies, seeking to avoid having to freeze or terminate their defined-benefit pensions, have converted them to "cash-balance" plans. While formally a defined-benefit plan, and thus eligible for PBGC insurance, a cash-balance plan is a hybrid, and functions much like a 401(k). Each worker is given a portable account credited with a percentage of pay, with interest buildup, each year. When the employee retires or leaves the company, he gets the accumulated balance, usually in the form of a lump sum.

Dozens of Fortune 500 companies have adopted this type of arrangement. At present, cash-balance plans account for 25 percent of all participants in defined-benefit plans, and 40 percent of all defined-benefit-held assets. But this option is in real jeopardy due to union opposition and especially a misguided court decision last summer. In *Cooper et al. vs. IBM*, a federal judge (Southern District of Illinois) ruled that IBM's cash-balance funding plan illegally discriminated against older employees. The company is appealing the decision. Should it lose, the shift by U.S. companies toward 401(k) plans almost without question will be that much more pronounced.

Transforming the Pension System

Attacking the competence or integrity of Pension Benefit Guaranty Corp. misses the larger point, as does denouncing the new pension law as "corporate welfare." PBGC is trying to cope with a broad mandate set forth by Congress 30 years ago with consequences few could foresee at the time.

The root of the problem is the inherent unsoundness of State-granted guarantees to firms (and unions) against market failure. Protecting workers from a pension meltdown *seems* a stabilizing and decent thing to do. But in retrospect, it is clear that "stability" has been achieved by inviting the likelihood of a far greater crisis down the road. By substituting a government guarantee for a market test of profit and loss, the PBGC created a moral hazard that ended up subsidizing instability and today threatens to impose huge costs on taxpayers.

Congress, under the new two-year law, is required to study the nature and extent of pension underfunding. Under pressure to maintain the solvency of the system, the final report may recommend several courses of action: better measurement of liabilities, improvement of information availability, and revision of actuarial assumptions about mortality and retirement. Though welcome, such measures would avoid addressing the urgency of transforming the federal pension insurance system into one in which risk and reward are in sync. In the end, only full privatization of PBGC, thus putting the corporation on the same footing as other insurers, can do

that. The program would then need to take its own shape according to the dictates of the market.

Such action hardly could be more imperative in an era when people retire earlier and live longer. PBGC data show that American men who retired during the period 1950–55 could expect to collect their pension for 11.5 years; for men who left the work force during 1995–2000, the figure had lengthened to 18.1 years. The strains on the nation's entire elderly-support system, not simply on traditional pensions, have grown enormous. Back in 1935, when Social Security was established, U.S. life expectancy, though already having risen substantially, was roughly 65 (even less for men).

Life expectancy today is about 80 for women and 75 for men, one result of which has been a declining ratio of active workers to beneficiaries. Most current workers sense, properly, that Social Security checks alone won't ensure a comfortable retirement. The program provided persons retiring in 2003 at age 65 with an average benefit level of 41.3 percent of immediate pre-retirement earnings. This "replacement rate," as it is known, dropped to only 38.5 percent after factoring in payment of Medicare Part B premiums.

Convincing young workers to support a population of retirees steadily growing proportionally as well as numerically is a tough political sell. Labor Department data for defined-benefit pension plans show that the ratio of contributors to recipients, which had exceeded 3 to 1 in 1980, now stands even at 1 to 1, and will dip even lower over the next several years.

Even if Congress, the administration and new PBGC Executive Director Bradley Belt can resolve this dilemma, they will be faced with another reality: Social Security, Medicare and other retirement-support programs collectively now account for about 40 percent of the federal budget, up from 30 percent in 1980. This proportion should rise further, thanks to the Medicare drug-prescription "reform" package passed by Congress and signed by President Bush last fall, which the White House admits will raise the program's total cost by an additional $534 billion over the next 10 years.

In light of the Census Bureau's projection that the number of Americans aged 65 and over will nearly double between now and 2030, we may wind up like Europe and Japan sooner than we think.

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The First Psychological Mistake Investors Make: Thinking They Know More Than They Do

By John Mauldin for Early to Rise

Economists frequently assume that people will learn from their past mistakes. Psychologists find that learning itself is a tricky process. Many of the self-deception biases tend to limit our ability to learn. For instance, we are prone to attribute good outcomes to our skill and bad outcomes to the luck of the draw. This is "self-attribution bias." When we suffer such a bias,

we are not going to learn from our mistakes, simply because we don't see them as our mistakes.

Furthermore, we make up reasons to deceive ourselves. The two most common biases are "overoptimism" and "overconfidence." For instance, when teachers ask a class who will finish in the top half, on average around 80% of the class thinks they will! Not only are people overly optimistic, but they are overconfident as well. People are surprised more often than they expect to be. For instance, when you ask people to make a forecast of an event or a situation, and to establish at what point they are 98% confident about their predictions, we find that the correctness of their predictions ranges between 60% and 70%! What happens when we are only 75% sure or are playing that 50-50 hunch?

Overoptimism and overconfidence tend to stem from the "illusion of control" and the "illusion of knowledge." The illusion of knowledge is the tendency for people to believe that the accuracy of their forecasts increases with more information. So dangerous is this misconception that historian Daniel Boorstin opined, "The greatest obstacle to discovery is not ignorance -- it is the illusion of knowledge." The simple truth is that more information is not necessarily better information. It is what you do with it, rather than how much you have, that matters.

This leads to my first guideline: You know less than you think you do.

The illusion of control refers to people's belief that they have influence over the outcome of uncontrollable events. For instance, people will pay more for a lottery ticket that contains numbers they choose than for a random draw of numbers. People are more likely to accept a bet on the toss of a coin before it has been tossed than after it has been tossed and the outcome hidden, as if they could influence the spin of the coin in the air! Information once again plays a role. The more information you have, the more in control you tend to feel.

Overoptimism and overconfidence are a potent combination. They lead you to overestimate your knowledge, understate the risk, and exaggerate your ability to control the situation. This leads to bold forecasts (overoptimism and overconfidence) and timid choices. In order to redress these biases: The second psychological mistake that investors make is that they are less certain in their views -- and aim for timid forecasts and bold choices.

Monetizing Envy and America's Housing Bubble

by Eric Englund

Envy is the basis of democracy. ~ Bertrand Russell

It is claimed that home ownership is the American dream. In days gone by, married couples would save enough money to make the once-standard 20% down payment on a house. Unless one could obtain financial assistance from a relative, there were typically no shortcuts to building up the savings necessary to make the aforementioned down payment on a starter home. Therefore, a future-oriented mindset would become the order

of the day (a wonderful and measurable side-effect, of future orientedness/low time preference, is that of low interest rates). Americans would sacrifice some current consumption and set aside the savings necessary to reach that home-ownership goal. The virtues of hard work, thrift, and discipline were rewarded when the day came that the local banker approved the mortgage loan – naturally, the local banker approved the loan as he took the time to get to know his customers and felt that hard-working, thrifty, and disciplined people were good credit risks. If you didn't have the work ethic and discipline to save for a house, then too bad; envy be damned.

Alas, these days are long gone. America has devolved from a republic to a social democracy. Politicians exploit, and pander to, the basest of human feelings: envy. In turn, everyone is now entitled to own a home. Indeed, even if the federal government needs to redistribute wealth, to help Joe and Jane Slackard buy a home, then redistribution it will be. If interest rates are too high, because of a present-oriented American populace (i.e., Americans don't save anymore due to high time preferences), then the Federal Reserve will lend a helping hand by creating billions upon billions of dollars – right out of thin air – in order to drive down interest rates. In essence, the Federal Reserve is monetizing envy (or should I say unleashing "animal spirits") so that everyone can borrow and spend to buy a home, furnish it, put two new cars in the garage, and live the American dream. Of course, the United States' housing bubble is going to end in an economic nightmare.

With key factors falling into place, it appears this housing bubble has come about as an accident of history. For example, as alluded to above, the Federal Reserve has driven down interest rates (through its massive monetary pumping) to levels not seen since Eisenhower was in office. Keep in mind that even the Maestro, Alan Greenspan, cannot know where the dollars will flow. Credit has been "democratized" – i.e., if you have a pulse you can qualify for a home loan. The United States has devolved from a republic to a social democracy in which its citizens, for the most part, have become rude, lazy, stupid, and hedonistic (all characteristics of a people with high time preferences – refer to page 68 of *Democracy: The God That Failed*). Finally, let's add in to the mix several gargantuan federal housing assistance/redistribution programs that serve to reinforce high time preferences. When combining all of these factors, a volatile cocktail has been concocted. Inevitably, when a high-time-preference populace collides with artificially low interest rates, something unsavory is going to happen. In this case, the monetary "energy" unleashed – as directed by the raging animal spirits of monetized envy – is flooding into the housing market. What has ensued is a housing bubble destined to go supernova.

How in the world have we gotten here? I'll try to explain.

ENVY AND PRIVATE PROPERTY

A society that is peaceful and prosperous is one that absolutely respects private property rights. Private ownership, in the means of production, is the cornerstone of capitalism. The high standard of living, enjoyed in the U.S., would not have come about had our founding fathers not understood the fundamental importance of protecting private

property rights. Such protection served to suppress mankind's natural envy and was crucial to the formation of a civil society.

James Madison understood that one man's property ownership could spark envy in another. He wrote the following in *The Federalist #10*:

> So strong is this propensity of mankind to fall into mutual animosities, that where no substantial occasion presents itself, the most frivolous and fanciful distinctions have been sufficient to kindle their unfriendly passions and excite their most violent conflicts. But the most common and durable source of factions has been the various and unequal distribution of property. Those who hold and those who are without property have ever formed distinct interests in society.

The framers of the U.S. Constitution purposely crafted this document to insulate the federal government from the passions, envy, and impulses of the populace. By all means, a pure democracy was to be avoided. This is why only members of the U.S. House of Representatives would be elected by a direct popular vote. Senators were selected by the state legislatures. The President was selected by an electoral college, while Supreme Court justices were appointed by the President. Accordingly, to paraphrase Benjamin Franklin, our founding fathers gave us a republic if we could keep it.

One may ask why democracy and direct accountability to the populace were feared by the framers of the Constitution? James Madison addresses this in *The Federalist #10*: "Hence it is that such democracies have ever been spectacles of turbulence and contention; have ever been found incompatible with personal security or the rights of property; and have in general been as short in their lives as they have been violent in their deaths." Democracy does not pave the way for peace, prosperity, and civility. Democracy endangers private property rights and therefore liberty itself.

Helmut Schoeck's research, pertaining to the topic of envy, bears out the importance our founding fathers put on insulating the federal government from the whims and political pressures brought forth by the citizenry. Dr. Schoeck stated the following in his masterful book *Envy: A Theory of Social Behaviour*: "Most of the achievements which distinguish members of modern, highly developed and diversified societies from members of primitive societies – the development of civilization, in short – are the result of innumerable defeats inflicted on envy, i.e., on man as an envious being." To defeat envy is essential for liberty to flourish.

LOSING THE REPUBLIC

We have not kept the republic. America is now a social democracy. Politicians shamelessly pander to envy by constantly promising and undertaking massive redistributions of wealth. This has come about due to the unconscionable degradation of the Constitution. Although the following list is far from complete, it should be instructive as to how we have lost our republic:

- With the right to secession abolished, for now, as a result of the Confederacy's defeat in its bid for independence (mistakenly called the Civil War), the stage was set for our decentralized federal system to become the vast centralized leviathan of today.
- In 1913, the 16th Amendment was ratified allowing the federal government to directly tax your income.
- Also, in 1913, the 17th Amendment was ratified providing for the direct election of Senators.
- In late 1913, the Federal Reserve was established. In turn, the fractional reserve banking cartel was born and the destruction/depreciation of the dollar began.
- FDR brings us the New Deal (of which many ideas were stolen from that social engineer, Herbert Hoover). Wealth redistribution firmly takes root. **As part of the New Deal, the Federal Housing Administration (FHA) was established in 1934.**
- LBJ's Great Society further expands the welfare state.
- The 1964 Civil Rights Act
- In 1971, Richard Nixon completely severs the dollar's link to gold. The dollar becomes nothing more than a fiat currency.
- The Patriot Act
- The Homeland Security Act

Regrettably, this list could be expanded exponentially. Clearly, the U.S. has become a social democracy. In fact, it is now a welfare-warfare state. As John Adams wrote in a letter to Thomas Jefferson "…democracy will envy all, contend with all, endeavor to pull down all, and when by chance it happens to get the upper hand for a short time, it will be revengeful, bloody, and cruel." (This remarkable quote was found in the footnotes of page 103 in Hans-Hermann Hoppe's spectacular book *Democracy: The God That Failed*). .

Yes, we have lost our republic. If we must judge the Constitution our founding fathers so carefully crafted, to protect our liberties (thereby attempting to prevent the emergence of democracy that John Adams so forcefully described above), then the Constitution must be judged a failure.

DEMOCRACY AND HOUSING FOR ALL

With the New Deal came federal government intervention into the private housing market. The Federal Housing Authority (FHA) was established in 1934 with the objective of rescuing a housing industry that "...was flat on its back." The following reasons were given for the creation of this federal monstrosity during the Great Depression (as found on the Department of Housing and Urban Development's website):

- Two million construction workers had lost their jobs.
- Terms were difficult to meet for homebuyers seeking mortgages.

- Mortgage loan terms were limited to 50 percent of the property's market value, with a repayment schedule spread over three to five years and ending with a balloon payment.
- America was primarily a nation of renters. Only four in ten households owned homes.

In 1965, the FHA became a part of HUD. On a combined basis, the "FHA and HUD have insured almost 30 million home mortgages and 38,000 multifamily project mortgages representing 4.1 million apartments, since 1934." Undeniably, the federal government's intervention into the housing market has been enormous.

Since 1934, an alphabet soup of government agencies and government sponsored enterprises (GSEs) have intervened in America's housing market with the objective – as stated on Ginnie Mae's website, using this agency's statement as a proxy – to "...help make affordable housing a reality for millions of low-and-moderate-income households across America by channeling global capital into the nation's housing markets." In addition to Ginnie Mae, other federal agencies involved in the housing market include the Department of Veteran Affairs, the Department of Agriculture's Rural Housing Service, and HUD's own Office of Public and Indian Housing. Not to forget the GSEs, Fannie Mae and Freddie Mac have become behemoths in providing liquidity to the housing market.

If the truth be told, this massive bureaucracy of federal and quasi-federal agencies is nothing more than an intellectually-bankrupt monument to political pandering focused on property envy. With the Federal Reserve's accommodation, this envy can be monetized so that even the poorest credit risk can qualify for a mortgage loan.

Unfortunately, such federal intervention into the marketplace creates the illusion that the free market is not to be trusted when it comes to housing. The argument goes that, without government, people would be either homeless or lifetime renters with no prospects for home ownership or even basic shelter. In essence, only the wealthy would own homes. Such intervention actually serves to further mold people into high-time-preference sloths unwilling to work hard and to save in order to buy a home.

POLITICAL PANDER BEARS

With a presidential-election year upon us, shameless political pandering is in full view. John Kerry is promising universal health care as we hear the tired old assertion that health care is a right. Not to be outdone, President Bush is playing the envy card when it comes to housing. Even if the Federal Reserve Bank of New York denies there is a housing bubble, the Bush Administration certainly has taken notice of America's red-hot housing market. So, of course, President Bush is going to take credit for this "success." Nevertheless, he is tweaking his message with a twinge of envy as more Americans deserve to own homes – which of course means more government "help" is on its way. What follows is an excerpt from President Bush's March 27, 2004 radio address:

> Good morning. This week brought good news about home ownership in America. The Census Bureau reported that new home sales in February rose to an annual pace of 1.16 million homes, a 24 percent increase over the past year. This success follows one of the most impressive years in America's housing industry. More homes were sold in 2003 than ever before. Housing starts last year were at their highest level in a quarter century. Rising home values have helped take the wealth of American households to a new record level.
>
> In our growing economy, more Americans can afford a new home. Incomes are rising. The unemployment rate is falling. Mortgage rates are low. And because of tax relief, Americans have more to save, spend and invest – and that means millions of American families have moved into their first homes.
>
> Our nation's 68 percent homeownership rate is the highest ever, and our government is taking steps to make owning a home a reality for more Americans, especially minorities and those with low incomes. In June 2002, I set the goal of adding 5.5 million new minority home owners in America by the end of this decade. Since then, more than 1.5 million minority families have moved into houses of their own. And for the first time, most minorities own their own home.

To this end, President Bush and Congress have been playing the property-envy card that must warm the hearts of all redistributionists. On December 16, 2003 "The American Dream Downpayment Assistance Act" was signed into law. For first-time homebuyers, this act will provide $200 million of federal funding to assist lower income and minority households to make a downpayment on a home. The amount of the downpayment assistance – i.e., redistributed money – may not exceed $10,000 or six percent of the home's purchase price, whichever is greater. Here again, the message is why work hard and save for a downpayment when the federal government will provide you with a shortcut? High time preference certainly is being fostered here.

As if this wasn't enough, Congress is pushing legislation named the "Zero Downpayment Act." According to Congressman Ron Paul (of Texas), this "...legislation is considered completely uncontroversial by both political parties, and will breeze through the full congress later this summer with the blessing of the administration. Nobody in Washington thinks twice about another welfare scheme that further entrenches the something-for-nothing mentality so prevalent today in America."

Dr. Paul went on to state the "…Zero Downpayment Act, as its name suggests, creates a federal program that allows some homebuyers to obtain federally-insured mortgages without making a down payment. 'Federally-insured' really means taxpayer-insured, as taxpayers like you foot the bill for defaults. So while Congress congratulates itself on yet another program that supposedly helps the poor, it is taxpayers who pay for the inevitable defaults."

Perhaps President Bush, and current members of Congress, see new homeowners as a voting block. Predictably, these political pander bears claim that government-assisted

home ownership strengthens our democracy by allowing increasing numbers of American families to live in homes they can call their own. So the message goes thusly: "Hey, I helped you buy your new house, so give me your vote." Pandering indeed.

THE HOUSING BUBBLE

The Federal Reserve Bank of New York published a report stating that it found little evidence of a nationwide housing bubble. Such a report lacks any credibility in light of the Federal Reserve's inability to identify the dot.com and telecom bubbles that eventually burst and brought the NASDAQ crashing down. Evidence, of a housing bubble, abounds.

Doug Noland, of *The Prudent Bear*, has performed excellent research with respect to the United States' housing bubble. The following excerpt comes from Mr. Noland's June 25, 2004 *Credit Bubble Bulletin* – subtitled *The Mortgage Finance Bubble*:

> As I have argued for some time, the mortgage finance bubble is the crucial issue. And the evidence of historic credit excess is anything but inconspicuous. Over the past seven years (Q1 1997 to Q1 2004), total home mortgage debt has surged 94% to $7.376 trillion. Total mortgage debt, including commercial and multi-family, is up over the same period by 93% to $9.618 trillion. Looking at the source of mortgage finance, bank real estate loans have doubled in seven years to $2.386 trillion. Over the past 53 months (for which I have data), combined Fannie and Freddie books of business have surged 78% to $3.677 trillion. Over the past six years, Federal Home Loan Bank assets have surged 140% to $857 billion.

Mr. Noland also points out that total mortgage credit increased by $1 trillion in 2003 alone. His research also found that, over the past six years, prices for new and existing homes have increased by about 50%. The Federal Reserve Bank of New York's denial of a housing bubble is a denial of reality.

Other excellent information is available with regard to the housing bubble. For example, the Ludwig von Mises Institute has published three excellent essays, about America's housing bubble, and are listed as follows:

- *Housing Bubble: Myth or Reality* by Frank Shostak
- *The Housing Bubble* by Christopher Mayer
- *Housing: Too Good to be True* by Mark Thornton

As Dr. Shostak stated in his most excellent aforementioned essay: "We can define a bubble as activities that spring up on the back of loose monetary policy of the central bank. In other words, in the absence of monetary pumping these activities would not emerge. Since bubble activities are not self-funded, their emergence must come at the expense of various self-funded or productive activities."

To buttress Dr. Shostak's analysis, I also offer up the following analysis from Francois Sicart of Tocqueville Asset Management: "…prices first reflect real-life observations, and then project them into the future. In the process, there is a point at which market prices start incorporating more hope than reality but, to the ignorant and insecure crowd, price rises merely serve as confirmation of the original concept. As a result, the more prices become disconnected from reality the more the crowd feels compelled to join in – and we then have a bubble." Although Mr. Sicart was referring to the stock market, in this essay, his analysis applies to the housing market as well.

To say the least, the amount of money that has flowed into housing is shocking. In a compressed time span, Americans have spent trillions of dollars on new and existing homes. When housing prices rise by 50%, in such a short period of time, to call this phenomenon anything other than a housing bubble defies logic.

BRIEFLY: THE FREE MARKET AND HOUSING .

Under a 100% gold standard, a housing bubble would not emerge. In fact, a house would be nothing more than a consumer durable that depreciates over time. Moreover, under a 100% gold standard, the prices of goods and services would decline over time as mild deflation would be a welcome part of everyday life.

Just think of it, the value of savings would increase while housing prices gradually decreased. The free market itself would bring about affordable housing. When planning for home ownership, such virtues as working hard, saving, and thrift would once again emerge in our thought processes. The mere thought of needing government intervention, to make housing affordable, would be laughable.

THIS WILL NOT END WELL

What George W. Bush, Alan Greenspan, and nearly all politicians don't understand is that they are encouraging millions of Americans to commit financial suicide. Government intervention into the marketplace has driven interest rates to artificially low levels while also making it childishly easy to secure the credit necessary to buy a house. Such low rates have enticed people to purchase homes at ridiculously high prices. However, these low rates are not sustainable in a social democracy which inherently is populated by people with high time preferences. High interest rates go hand in hand with high time preferences (for more about this, refer to pages 62–65 of *Democracy: The God That Failed*). The Federal Reserve cannot keep a lid on interest rates forever. Thus, as interest rates rise, interest-rate sensitive "investments" will decline in value. This does not bode well for homeowners.

So what is going to happen? It certainly appears that Alan Greenspan's loose monetary policy has done more than inflate a housing bubble. Prices of goods and services are rising as well now (even though the grossly manipulated CPI indicates only mild price inflation). Should the bond market get a whiff of real inflation, then an inflation premium will be priced into long-term bonds – i.e., interest rates will rise sharply and bonds will

fall. At this point, the bond market will show that Alan Greenspan is behind the curve and he will be forced to dramatically increase short-term interest rates in order to slay the inflation dragon. Such a scenario, of rising interest rates, will pummel the housing market and will leave millions of homeowners with negative equity in their homes. Mortgage defaults will rise, especially on adjustable rate mortgages, and this will be a financial disaster that will make the S&L crisis pale in comparison – keep in mind that we are talking about trillions of dollars in home loans and federal mortgage guarantees.

Without a doubt, America's social-democratic homeowners won't take personal responsibility for their own financial recklessness and will demand that heads roll. Should the publicly held (and quasi-governmental) companies such as Fannie Mae and Freddie Mac require government bailouts, then the public may demand that Franklin Raines – Fannie Mae's CEO – and others do the perp-walk and face trial like Martha Stewart and Kenneth Lay. Fannie Mae's and Freddie Mac's financial auditors may face the same fate as Arthur Andersen. Senators, House Members, and the President will all be demanding investigations and public hearings. In spite of their implicit culpability, while America's financial system teeters on the abyss, these politicians will go on the offensive and somehow lay blame on all private companies involved with real estate – and call them "fat-cat, capitalist exploiters." In the end, politically-motivated pandering to envy may leave us with a nasty, brutish, and impoverished democracy. For envy truly is the basis of democracy and thus can never provide a stable foundation for peaceful self-governance let alone the housing market.

Eric Englund [send him mail], who has an MBA from Boise State University, lives in the state of Oregon. He is the publisher of The Hyperinflation Survival Guide *by Dr. Gerald Swanson. You are invited to visit his website.*

The Importance of control

Should You Trust The Stock Market?

Dear YOUNG MONEY:

I was flabbergasted by Mark Cuban's comments about investing in the stock market in your Summer 2003 issue ("The stock market is probably the worst investment out there".) Does he really believe that, or was he just suggesting we should beware of stockbrokers (as opposed to the market itself)? If I follow Mr. Cuban's advice to put my money in the bank, wouldn't inflation eat away at my savings? Didn't Mr. Cuban make his riches in the stock market? Didn't Warren Buffett do the same (albeit with a different approach)?

I thought the stock market was the best long-term investing vehicle available and that young people have an advantage as investors if they start early because they have more time for their investments to grow than someone who starts later in life. What gives? I, for one, would like some clarification from Mr. Cuban and would also be interested in YOUNG MONEY's position on these questions.

Best regards and keep up the good work.

Andrew Tempest

Seattle, Washington

CUBAN'S RESPONSE:

Warren Buffett never buys 100 shares of a stock and just holds it. He, like myself, buys shares of stock to get some level of ***control*** of the company. That's far different than buying a stock and PRAYING that the stock goes up.

If you have the resources to take ***control*** of a company, and you think it's a great investment, do it. If you want to try to guess on some companies, buy their stock, and hope it goes up, you might as well go to Vegas, because you have no advantage at all.

Remember this little tidbit. Whenever you make a business deal, and that includes buying stock, always look for the fool... If you can't find the fool... It's you.

Interest rates are low right now, and that's frustrating, but cash doesn't lose 40 percent of its value in a year, stocks can.

Mark Cuban