A FINANCIAL STRATEGY TO
REIGNITE THE AMERICAN DREAM

HEADS I WIN TAILS YOU LOSE

PATRICK H. DONOHOE

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CHAPTER 7

A SOLID FOUNDATION

"Everyone has the ability to build a financial ark to survive and flourish in the future. But you must invest time in your financial education to build an ark with a solid foundation."

—ROBERT KIYOSAKI

Your financial statement is the scorecard that measures wealth-building activities—saving and investing. Your Human Capital Statement helps you identify wealth-creating opportunities—making more money.

My experience with many business owners and investors has taught me that wealth building has a foundation upon which your assets and liabilities grow. It's not your entire financial strategy—but it's arguably the most vital. The financial tool we recommend as your foundation dates to the turn of the twentieth century and has been used by wealthy families, big banks, and corporations. These guys understand the value of liquidity—they are the ones who capitalize on market downturns. This understanding originates from decades of experience with market and business cycles and the knowledge that life doesn't always work out as planned. They are prepared to prosper in those moments because they have a solid foundation.

I met Martin in 2011. He was a real estate developer, author, and entrepreneur—having started several businesses. He seemed to be wealthy—had a big house, drove a fancy SUV, and traveled to exotic places. Martin was charismatic. We had similar philosophical interests and hit it off immediately. I told him about my business and my perspective on securing a financial foundation before investing. Although my specialization intrigued him—setting up what I call The Wealth Maximization Account™—he sneered at me, sat back in his chair and, shaking his head, said, "Savings is for losers. I can make a 30 percent return in my sleep—that's a hard sell to a guy like me, Pat."

Years earlier, before 2008, I heard this statement a lot. Martin's words seemed to replay in my mind in slow motion, bringing back some not-so-fond memories of my personal liquidity crisis and those of many people I knew. I must admit, Martin's words caught me a little off guard since the aftermath of the crisis was still palpable.

Years later, Martin connected with me through a text—apparently one of his businesses had lost its biggest contract and his tech start-up was running out of cash. He only had two months left. He needed a $75,000 loan. His situation escalated from there and he was forced to take on partners and give them a hefty percentage of the companies. Martin had made millions, probably tens of millions up to that point, but he couldn't come up with $75,000. Fortunately, his business did rebound, but his share of the company was less now—much less.

Martin would have benefited from a solid foundation.

YOUR FOUNDATION: THE WEALTH MAXIMIZATION ACCOUNT

Imagine what you would want out of a foundational asset before you started to put a portion of your assets and earned income into it. What would you want the account benefits to be? Here are the common responses I have received over the years:

- Availability or liquidity on demand
- A good return
- Insured or guaranteed to not lose money
- Tax favorability
- A simple transfer of ownership
- Private and possibly protected from creditors

- No limit to yearly contribution amounts
- Offered and administered by a reputable company

The Wealth Maximization Account (WMA) offers you these attributes and more.

The WMA is a uniquely designed whole life insurance policy with a paid-up additions (PUA) rider that creates instant liquidity. It is offered by a private mutual insurance company.

The design of the policy, specifically how much PUA can be added, adheres to the Internal Revenue Code Section 7702, which defines the maximum contribution level of a life insurance policy without the growth being taxed.

A mutual life insurance company is a private corporation owned by specific account owners, referred to as participating policyholders. Participating also refers to the payment of company profits to policyowners through a dividend.

The WMA is your ideal foundational asset. It is the only asset that exists to offer numerous foundational benefits. The growth is free from income, dividend, or capital gains tax. The cash value is liquid. Annual growth is contractually guaranteed. If the insurance company is profitable, they distribute a dividend on a pro rata basis to each policyowner. The insurance company guarantees a line of credit against the total amount of policy cash value. The value is private and typically not subject to the claims of creditors. The face value or death benefit protects the beneficiaries against the policyholder's premature death. The death benefit can satisfy creditors, settle business or real estate debts, fund college education, pass on a legacy, and more. The policy can be pledged as collateral and can be used to improve the financial situation of an individual, investor, or business owner.

To be fair, the WMA isn't going to yield double digits per year. By itself, it isn't going to make you wealthy. Rather, it's your foundation, where you store your reserves. It also fulfills much of the benefit of a typical investment, such as a mutual fund. When you factor in the tax benefits and low costs, the typical market investment mutual fund has trouble outperforming the WMA after fees and taxes. I'll show you some examples in later chapters.

Will your insurance policy give you the returns you need to have all your dreams come true through the magic of compound interest and tax-free cash flow? Maybe, maybe not—that is why it is the foundation, not where *all* your wealth is stored.

The following is a simple way to categorize the WMA and other types of assets you may acquire to build your wealth.

CLASSIFYING ASSETS

"The individual investor should act consistently as an investor and not as a speculator."

—BEN GRAHAM

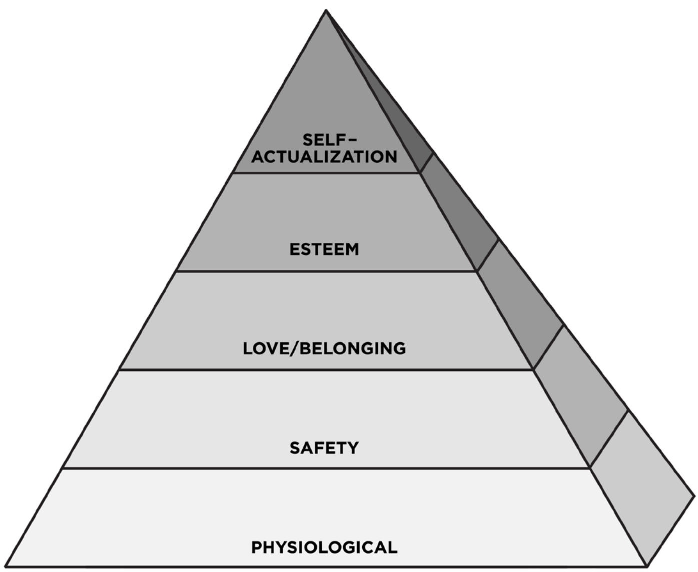
I like to classify assets in terms of risk and control and get the highest benefit for each class (rate of return). The more control you have over the asset, the less risk you have. The WMA is the ideal foundation because you have optimal control, protection, and a great return.

To classify other assets by these terms (risk and control), I developed an easy-to-understand model that helps you prioritize wealth building. I call it The Hierarchy of Wealth™, modeled after the famed psychological model, Maslow's Hierarchy of Needs.

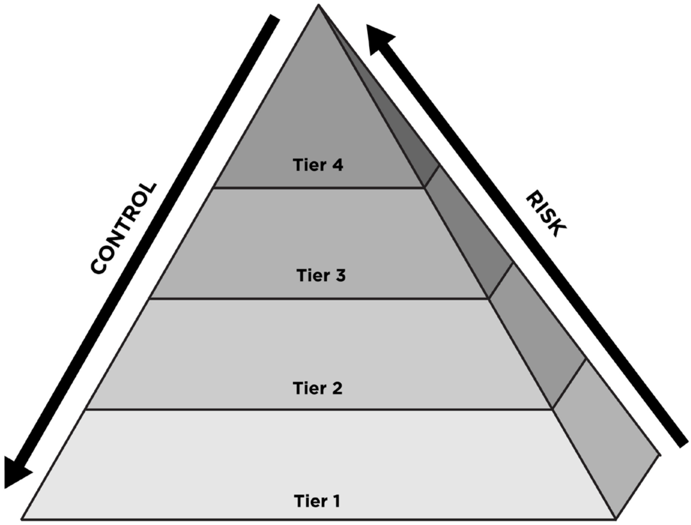
The Hierarchy of Needs, developed by psychologist Abraham Maslow, is a five-stage model that describes the motivation behind human behavior and does so sequentially. The foundation is Physiological, then Safety, Belonging, Self-Esteem, and finally Self-Actualization.[57] Maslow found that you must have your physical needs like

57 Physiological needs: air, food, drink, shelter, warmth, sex, sleep. Safety needs: protection from elements, security, order, law, stability, freedom from fear. Belonging needs: friendship, intimacy, trust, acceptance, receiving and giving love, affiliating with a group. Self-esteem needs: esteem for oneself (dignity, achievement, mastery, independence), and the desire for reputation or respect from others. Self-actualization needs: realizing personal potential, self-fulfillment, seeking personal growth and peak experiences, and a desire to become what one is capable of.

food and shelter before you seek safety such as humane living conditions or a stable community. These needs come before the innate desire for relationships, and then your pursuit of self-esteem comes after that. Finally, discovering your purpose and passion—what Maslow calls self-actualization—comes last. With this model, you can't skip steps. You don't fulfil your physiological needs and go right to discovering your purpose. Needs are fulfilled sequentially—one step at a time.



The Hierarchy of Needs model parallels the financial strategy I teach, The Hierarchy of Wealth. You start with the foundation—Tier 1, your safest capital—and build step by step through Tiers 2, 3, and then 4.



I work with clients to maximize their income-producing potential and optimize their financial statement. The goal is to put away 15 to 20 percent of earned income and then reallocate assets to align with The Hierarchy of Wealth. One of the first steps is to secure their foundation, Tier 1, by capitalizing their WMA.

Tier 1

Criteria: Guaranteed, liquid, prudent return, and control

Strategy: Put away 15-20 percent of earned income and establish 6–24 months of living expenses before moving to Tier 2.[58]

58 In *The Financial Strategy Study Guide,* I've made a video that illustrates the amount of money that leaves an average American's fingertips each month. It shows how you can more than double your wealth with a few simple adjustments. It is called the Maximum Potential Calculator.

Tier 2

Criteria: Control, collateral, cash flow, and consistency

Strategy: Invest in your personal development to make more money, which includes investing in your business. Invest in hard assets like residential real estate that you own, control, and that produces passive cash flow that you don't work for.

Tier 3

Criteria: No guarantees, limited collateral, no control, or control is relinquished to a professional.

Strategy: Once you have maximized your Tier 1 and Tier 2 assets, Tier 3 investments are next. They provide higher returns and have higher risk. Examples are hard money lending against collateral, or syndicated funds for hard assets such as real estate or commodities.

Tier 4

Criteria: No guarantees, no collateral, speculative, could lose 100 percent of the investment.

Strategy: Tier 4 is speculative investments where you can lose everything. This tier comes after at least 90 percent of your assets are in their respective Tiers 1, 2, and 3.

The Hierarchy of Wealth is a system that works. When used properly, it will make you wealthy. I have seen hundreds of different investments, strategies, and businesses. Some work. Many do not. Nobody sets out in business or investing with the intent of losing money; however, change happens—your wealth will always be subject to volatility, economic disruption, failed partnerships, new trends, technology, etc.

The bedrock of The Wealth Maximization Account provides you with the framework to conquer all these challenges and more.

Unfortunately, most individuals are simply hoping that Wall Street or a money manager will do all of this for them. Unfortunately, the typical financial strategy is built on a house of cards and, therefore, during market downturns 401(k)s become 201(k)s.

The approach most are taking with their wealth ends up looking like the opposite of The Hierarchy of Wealth—an inverted pyramid—where the riskiest assets have become their financial foundation and those assets that are the safest and most secure are at the top. When financial change comes like a recession or market downturn, those with an inverted pyramid are wiped out, and those with a solid foundation typically pick up the pieces, take advantage of opportunities, and do very well.

Adhering to The Hierarchy of Wealth ensures you are on top—*Heads You Win, Tails They Lose.*

THE VALUE OF LIQUIDITY DURING UNCERTAIN TIMES

I met Allan, a securities and tax attorney, during the spring of 2010. He had been clobbered by the real estate debacle and was unwinding several projects that had gone south. Fortunately, he landed an exclusive contract with another firm and investment group that paid him $200 per hour. He was working 70-hour weeks trying to dig himself out.

We hit it off immediately—we were both going through many of the same challenges. He taught me a ton about real estate and securities law. The amount of fraud he witnessed during the real estate boom scared us both; we were very cautious about who could be trusted.

Allan had hunkered down and was committed to settling his debts, shutting down his real estate projects, and socking money away. He immediately grasped the idea of The Wealth Maximization Account. He understood its asset protection characteristics, tax benefits, and of course, the fact that the guarantees prevent loss, even in a market decline. However, we met during a period of extreme adversity and uncertainty and he was reluctant to make a move.

The final decision was to replace his expensive term life policy with a convertible term policy, which was less expensive and gave him more coverage. The goal was to convert parts of it over time to multiple Wealth Maximization Accounts as his situation changed.

Allan took a long time to make the decision to start shifting his assets and savings. We met every year or so for three years, at which point he decided to convert enough for a $5,000 per year WMA. The size was extremely small relative to his earned income, but because I knew his cautious state of mind, I understood.

The year after, Allan had all his debts paid off and was in the clear regarding his real estate debacle. He had amassed savings of $200,000. He was six to 12 months away from beginning a real estate development project where he would be one of the principals. He would need to invest somewhere between $100,000 and $300,000 of his own capital in the project. He was comfortable saving $50,000 per year and could commit for seven years at this level. It took Allan several years to feel comfortable enough to go all-in with a WMA as his primary savings vehicle and primary source for his opportunity fund. He's financially better off—and he's emotionally better off as well. He considers his decision the best financial move he has ever made.

The hardest part of shifting your thinking is going against the conventional wisdom of typical financial planning and advice—max out your 401(k) contributions, invest in mutual funds, and bet on the stock market for long-term returns and wealth. It's hard to buck the advice that just about every financial advisor gives you. It's hard to explain to your family and friends why you're doing something so different. You might also mistakenly think it's hard and complicated to set up these accounts and that you'll need to pay an advisor a ton of money to do it right. All those pressures might combine to keep you from acting in your own financial interest.

KEY TAKEAWAYS

- The wealthy think differently. They don't gamble and sacrifice their wealth.
- You are your own best financial asset. No other asset can replace an investment in yourself through training and education.
- Know yourself. Use personality assessments to learn your strengths and weaknesses and find the work you love.
- Know your options and leverage them.
- Use The Hierarchy of Wealth to position your current assets and prioritize new investments you make.

Now it's time to take what you've learned so far and apply it.