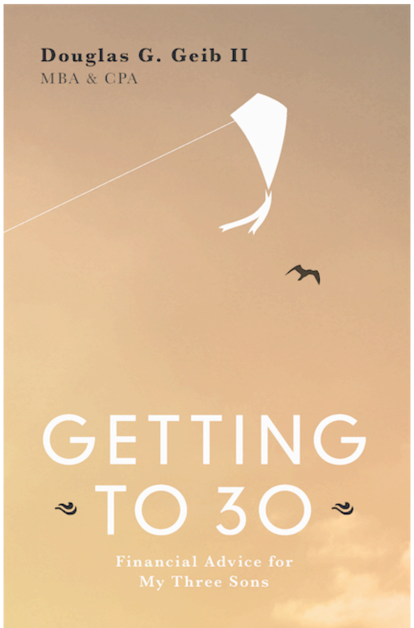

A path to financial independence for a high school graduate.

Getting to 30, Financial Advice for My Three Sons

by Douglas G. Geib II

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Douglas G. Geib II
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GETTING TO 30

Financial Advice for My Three Sons

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ISBN 978-1-63492-204-3

Printed on acid-free paper.

Published by BookLocker.com, Inc., Bradenton, Florida.

Booklocker.com, Inc
2017

Cover design by Brandon Geib

Set in Baskerville and DIN

Layout design by Brandon Geib

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UNDERSTAND MONEY

PRINCIPLE IV

8. THE RISE OF HOT MONEY

The marvel of history is the patience with which men and women submit to the burdens unnecessarily laid upon them by their governments.
— **GEORGE WASHINGTON**

Let's review just for a moment the purpose of money. When people accept a common currency as a medium of exchange it makes it easier to establish a relative value between different goods and services and therefore buyers and sellers can trade much more conveniently. In addition, if people have trust in the common currency, then other modes of payment (like electronic money) can anchor themselves to this currency. People have a tendency to forget, for example, that the real purpose of "credit cards" (when they were introduce over 50 years ago) was to make trade more convenient (especially as the automobile increased the mobility of the U.S. society); not to accelerate consumption.

Although money facilitates trade, it is America's consumer driven free market economic system that creates the jobs that enhance our standard of living. It took time, but the early trailblazers of our Nation eventually did develop the entrepreneurial skills necessary to harness the potential embedded in our natural resources. This virtuosity and independence was our strength and it fostered a culture and economic power that became the envy of the modern world. Over time, our decision to continue to trade with other countries was not because we had to. It was because our leaders understood that when we imported goods from war torn nations (like Japan and Germany) and emerging countries (like China and India) it allowed us to export freedom, democracy and economic stability. Trade made the earth a more secure and peaceful ecosystem, lifting millions who lacked our ingenuity, knowledge, resources and philosophy, out of the grips of poverty and despair.

In an ideal economy, every transaction is a "win win" for both buyers and sellers. Even so, in the real world, especially in a capitalist economic system, the most efficient and most innovative people and organizations tend to be the winners. It is this spirit of competition that helps to keep prices low and provides the right incentives for entrepreneurs to produce a wide variety of goods and services that consumers (which include businesses as well as individuals) want to buy. If the most successful competitors continue to invest their winnings to improve the lives of the American citizens, then society enjoys a perpetual renewal process that improves our standard of living while keeping us fresh and vibrant. Unfortunately, there are a group of winners that have no such desire. These individuals, and their political cronies, are slowly abandoning the fundamental principles that built this great economy.

The Fed Loses Control

As Americans we hate to lose. As responsible citizens we do so honorably; and then look for ways to improve so we increase the likelihood that we win the games of tomorrow. What happens when all of sudden the game changes, the rules get rewritten, the opponent cheats and the referees look the other way.

Specifically, what happens when overzealous CEOs lead a network of banks that hire incompetent and gullible workers? What happens when politicians interfere with the banks underwriting standards and legislate loans to those least qualified? What happens when the U.S. Treasury refuses to enforce the regulations that are suppose to keep the financial system solvent? What happens when the "invisible hand" of private enterprise grabs for the magic wand of government in its quest for a competitive advantage? What happens when the same government that prints the money now decides who gets it? What happens when we can no longer rely on our banks to allocate capital among the most worthy opportunities?

Well, two things happen. First, the banks distribute money to the least responsible and most speculative ventures. Second, the banks make bad loans, which ripple through the world's economy; and like a falling set of dominos, cause good businesses and responsible people to fail. When the magnitude of the bad loans becomes so significant that all of our major banks are on the verge of systematic collapse (which IS our situation in early 2009) then the Federal Reserve no longer controls how money zips around the world. As a result, the Fed can manipulate interest rates all it wants, and it will have minimal impact on the U.S. economy.

How can this be? Look at it this way. When a bank makes a bad loan, both the bank and the borrower lose in the transaction. The bank doesn't get its money back, and the borrower most likely files for bankruptcy. Is there a winner? Of course! If the borrower, for example, used the money to build a house, the winner could be the builder, the broker that processed the loan, the lawyer who did the paperwork, and/or various other parties involved in the supply chain. There is always a winner, because at the end of the day someone has the cash. And, guess what? It's not the bank!

Government, of course, exacerbates this situation every time it makes (or guarantees) a loan that is not repaid, spends money on unproductive programs, provides aid to corrupt foreign regimes or rescues the stakeholders (i.e. employees, creditors, shareholders, and suppliers) of failed business models. Tragically, the cumulative effect of the U.S. government's prodigal spending habits and the banks abysmal lending practices is to transfer trillions of U.S. dollars into the hands of some of the world's most reckless individuals. Unfortunately, our government really has no idea who is in control because they do not have the tools to inventory the Nation's money supply. The most likely scenario is that no one is in control. Yet numerous entities fight daily to expand the supply of money and to take a bigger slice of America's wealth. What we do know, however, is that these entities (and the people that run them) have very different goals and objectives than the Federal Reserve.

Speculators and Hot Money

As you grow older, there is a greater likelihood that you will be involved in discussions on what form of government (democracy or socialism) and what type of economic framework (private enterprise with a consumer focus or public ownership with a producer focus) is the best model to improve the standard of living of all Americans. Certainly these are important issues and you should participate in the conversations and debates. However, as a larger percentage of the U.S. money supply is decoupled from the auspices of the Federal Reserve, the greatest arbiter of wealth in most of the world's economies will be those entities who control what I call, "hot money". Thanks to our generation, those organizations have created (and will help sustain) the most volatile financial environment in history.

What is hot money? In general, hot money is any money that is not under the control of responsible citizens or the Federal Reserve. Responsible citizens invest capital to create (and sustain) the jobs in an attempt to improve the standard of living of all Americans. Hot money speculators accumulate and trade U.S. dollars just for one purpose – to get more dollars! At one time, the Fed's power to control the dollar bills circulating through our banking system was the fuel that kept the flame of our economic engine burning brightly. Today, hot money is what lights the fires that are slowly torching the world's banking systems.

Hot money represents the dollar bills that flow into the money supply when a) creditors don't repay their loans b) our politicians waste resources on inefficient an ineffective government programs c) we make investments that lose us money and d) we spend dollars on products and services we do not need and cannot afford. Hot money resides in the bank accounts of loyalists who lobby politicians to enact government programs for the sole benefit of special interests. Hot money is what our politicians create when they buy the toxic assets that weaken our financial system. Hot money does not reside in the pristine vaults of the U.S. Federal Reserve banks but in the murky dungeons of certain private equity firms, hedge funds and other shadowy entities located in the sinister underworlds of Antigua, Barbuda, Gibraltar, Malta, Montserrat, Nauru, Niue and Vanuatu.

The hottest money zips around the globe looking to burn the uneducated and inexperience. The thugs who control hot money don't care about sustainable economic growth, high levels of employment or low rates of inflation. All they want to do is make more money, and the hotter the better. They love to lavish gifts on naïve politicians: who are nothing but pawns being manipulated in a game they no longer understand. When businesses fail, the hot money pirates rejoice. When we borrow and buy things we don't need, they celebrate. When governments print more money to reward the reckless they cheer. When free markets allocate capital to the worst opportunities, they dance. When terror forces savers to retreat to the safety of government debt, they party. The more we ransom the economic viability of future generations the better. Instability, chaos and uncertainty only guarantee their growth and survival as they play a game of Russian roulette with our life savings.

There are a number of significant consequences to the overall economy as well as to each of you. Perhaps the biggest consequence of our banks' and government's ineptitude is that as a Nation we have built nothing of value for the trillions of dollars that have left our stormy shores for the sunny beaches that cater to the greedy. It's like borrowing money to construct a home and then finding out that the builder fled the country with your life savings and is sitting under a coconut tree in some far away land enjoying his cocktails. In other words, every time a loan (whether public or private) is not repaid (because of fraud, incompetence, banking crisis, poor regulation or whatever) it is the first signal that our economy has wasted resources and has given a big wad of dollar bills to somebody in the world.

What does it mean for you? Well, three important points. First, the sparks from hot money will cause future prices to bounce around like Mexican jumping beans. Second, the responsible people of our society will continue to face the burden of higher taxes (direct and indirect). Third, investing will feel more and more like you are taking a lot of risk with no reward. Let's take a moment and explore each of these in more detail. As we do, remember that these themes only reinforce that the age of uncertainty and instability are here. As a result, it is even more important that you use the principles in this book to traverse a difficult terrain, littered with pieces of the American Dream, thanks to the tyranny of the reckless.

A Volatile World

Think about this for a moment. If the supply of money is fixed, what causes prices to go up or down? In an efficient market driven economy the only thing that will cause the price of a product to change is the amount of customer demand relative to the product's supply. Consequently, if a manufacturer makes too much of a product relative to its demand, prices must fall in order to entice the consumer to buy its product. Conversely, if consumer demand exceeds a product's supply, then prices will rise in an attempt to dampen demand. The equilibrium price is when the overall consumer demand is equal to the product's supply. Given enough time, an efficient market will eventually find this clearing price for all products (and services).

As you now know, the supply of money is not fixed. In fact, there are trillions and trillions of dollars just sitting in the hands of hot money speculators just waiting for an opportunity to create havoc in any market. In 2008, this speculation is why oil prices doubled and then collapsed during a brief six-month period. As these bubbles inflate, the madcap specialists have become especially adept at "monetizing" these increases, which shifts even more dollars into the hands of the reckless. In addition, when hot money rushes into an asset class (such as any commodity, stock and/or bond) and then gushes out just as quickly, it is not possible to determine a product (or service) "clearing" price, resulting in a constant and volatile imbalance between supply and demand.

The consequence of this imbalance is that a market will produce either too much stuff (spawning deflation) or too little (creating inflation). Historically, the Federal Reserve could use interest rates to help manage through this imbalance. However, since the Fed really has no control over the money supply, this tactic is no longer effective (which is one reason that the Fed's long term interest rates are close to zero in 2009 and yet the banks have no money to lend). As a result, because of their own carelessness, our politicians are left with few options. For example, when prices deflate during a recession, the Federal Reserve has only two policy choices. Either a) give the economy sufficient time to work through the excess inventory and allow the market to find the equilibrium price or b) print more dollar bills and give it to the people so they have the funds necessary to buy the excess inventory (of course, at prices higher than the clearing price which helps to sustain jobs at businesses that should close their doors). What choice would you make?

The Fed should choose a, but not surprising, politicians hate long recessions, economic stagnation and rising levels of unemployment, so Congress (along with the U.S. Treasury) always pressures the Federal Reserve to print more U.S. dollar bills (i.e. the answer is b). These dollar bills enter the world economy through their typical process – wasteful government spending and loans to the least credit worthy customers. Once again, the dollar bills are deposited in the wrong places and over time the Fed loses even more control of the Nation's money supply. As a result, the international hot money entrepreneurs control an even larger percent of America's money supply and the vicious cycle of booms and busts repeat themselves, each time increasing in frequency and intensity. This is part of the financial disaster that our generation leaves to you.

To manage in this volatile environment you must recognize two very important points. First, consistent with hundreds of years of history, almost anything you consume from government (education, healthcare, utilities, etc.) will cost you more money in the future. Second, you have absolutely no ability to predict the movement of future prices in the commodity-based free market part of our economy. That is, depending on hot money flows, prices may increase substantially for some products and decline just as precipitously in a manner of months. This turbulence will be exacerbated by each political party's vacillating use of price controls, tariffs, import duties, excise taxes, tax credits, subsidies and other tools in an attempt to regulate prices.

Therefore, never buy a market-based product or service because you believe it will cost you more in the future. There is just as good of a chance that it will cost you less. For example, in the last year, people who historically bought anything on the supposition of rising prices, overpaid for homes, cars, investments, clothing, furniture, etc. Remember, you always have the ability to substitute a variety of products for most of your major needs (which of course can change significantly from year to year). Study the market trends and understand your options. Finally, if you see prices rising over a sustainable period of time there is a pretty good chance that a bubble is inflating in that asset class. If you haven't bought, then have the patience to wait. I can assure you that it is only a matter of time before prices will fall (most likely by a significant amount).

The Tax Burden of the Responsible

Long ago, perhaps beginning with President's Roosevelt's New Deal in 1933, government spending and future commitments exceeded the U.S. Treasury's ability to generate sufficient tax dollars from the weary public. Instead our politicians have polished their skill of vacillation through a revolving transfer of tax dollars among different American stakeholders in an elaborate and complex game of smoke and mirrors. The truth is, and our government knows it, the only possible way to finance current and future government spending is by printing more U.S. dollar bills. As we discussed earlier, this relentless production of money will continue to dilute the value of our paper currency as we behold the insidious transfer of wealth from responsible private citizens to government bureaucrats and their hot money brethren.

Yet, as we watch our government spend trillions of dollars that is suppose to benefit those less fortunate, how is it that none of the groups they lavish money on seem to get any better? It does make you wonder who really does benefit from their largesse. However, what's most unfortunate is that the reckless continue to penalize the responsible just for being – responsible! We do all the things that this book advocates – we become educated, control spending, avoid debt, and manage stress. In addition, we start the businesses that create the jobs and build the families that nurture our youth. We pay our taxes, invest our savings in our local banks and give willingly to charities and other worthwhile causes.

In the meantime, our politicians sit around in their local pizza parlors playing a game of whack a mole in the belief that action is better than reason as their policies and initiatives spin us further out of control. When it comes to taxes, it is always the responsible that bear the greatest burden. The irresponsible spenders (who by the way provide the fuel that flames the growth of hot money) have no money while the ignominious speculators have transferred most their dollars to the unregulated safe havens of sovereign lands.

There are other "taxes" that indirectly impact the responsible members of our society. As our government continues their futile negotiations to get back some of the hot money that they so effortlessly bestowed on the daredevils of capitalism, we sit with our savings in America's banks, earning a return that is a pittance relative to the value of this capital to the Nation's economic system. We subsidize the government's low interest debt and watch helplessly as our Treasury department guarantees returns to the hot money entrepreneurs in excess of ten percent in a one way bet that does nothing more than transfer more of our money supply into their shadowy dungeons. In our government's incestuous quest to increase liquidity they've done nothing more than ratchet up uncertainty and volatility, while increasing the likelihood that the hot money radicals will continue to hold our economy hostage in the future. In addition, if you are a responsible saver, then it will cost you more to educate your children since the government's "financial aid" formulas are designed principally to benefit the spenders and other members of the tyranny of the reckless. These are just a couple of examples of the various forms of escalating "confiscatory" taxes that we leave as our legacy to the responsible people in your generation.

The New Asymmetry of Risk

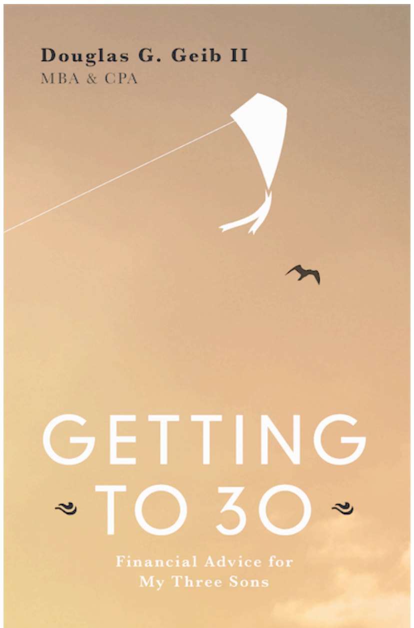
The historical view of risk and reward implies that if an investor (i.e. a saver who provides capital to a borrower) takes on greater risk, then one must be compensated for this risk. The way investors are compensated for risk is by earning a return on the capital (or money) they invest. Interest rate is the metric that one uses to benchmark a return and to measure this risk. For example, if you have a choice between two investments, A or B, and if the rate of return on A = 5% while the rate of return on B is 10%, then one normally would assume that B is the more risky investment.

There are many variables that impact risk. The most important variables are certainty (or uncertainty) and time. For example, although most people consider an investment that is guaranteed by the U.S. government the safest in the world (i.e. a high certainty of repayment), a U.S. Treasury Bond that matures in 30 years will generally have a greater return than a similar security that matures in ninety days. In addition, everyone measures risk differently depending on his or her background (e.g. education, age, sex, nationality, etc.). For example, my assessment of investing in a new company building telecommunications systems in Peru may be totally different than a Peruvian engineer with numerous relationships and local financial resources.

Most sophisticated investors assume a certain symmetry when they assess the probability of gain against the probability of loss. For example, if your expected loss is zero (which indicates that you never intend to lose money), then an investment that has a 50% probability of making 8% also has a 50% probability of losing 8%. Unfortunately, in today's volatile world where hot money renders sound fundamental analysis meaningless, and the U.S. government can arbitrarily select winners and losers, the ability to accurately determine these probabilities are almost impossible. The consequence, of course, is that investors can provide billions of dollars to government agencies (like Fannie Mae and Freddie Mac) and private corporations (like Lehman Brothers and Bear Stearns) and then find out that that in a matter of months their investments are now worth zero. In other words, the probabilities are no longer symmetrical which implies that an investment with a 90% likelihood of making 8% could just as likely have a 90% probability of losing 100%. Ergo, risk with no reward. This market asymmetry when it comes to assessing risk will have tremendous consequences on your generation.

One of the first things you will notice is that the financial services industry will become even more astute at marketing the benefits of risk and reward. Of course, when you think about it, no industry in America has done such a masterful job already of linking these two concepts. If you smoke more cigarettes is there more reward? If you eat fatty foods is there more reward? If you drink more wine is there more reward? Nevertheless, the financial firms want you to believe (and without this belief they basically have nothing to sell to you) that investing in riskier assets will bring you greater rewards. Well, here's my message to you. When it comes to investing, when people say Risk you should immediately think Loss.

Unfortunately, you are maturing in an age of less transparency, escalating uncertainty and more complexity. What you must understand is that hot money speculators are increasingly using political forces as their tools to gather inside information and to create, identify and exploit conflicts of interest. Their ability to use the supply of money to influence the prices of the most common goods and services makes it impossible for our core markets to operate efficiently (i.e. where prices are relatively stable and trends are predictable). Certainly the hot money speculators will continue to trade dollars among themselves, but their coffers increase principally at the expense of the naïve and the inexperience. Today, that person is you. Tangling with these doyens of disaster in the market is like challenging Tiger Woods to a scratch game of golf. You will lose. Since you must master the skills of a saver before you can develop the wisdom of an investor, this is not something that should concern you at this time. By the time you become a savvy saver, Book II will be waiting, with the knowledge that will teach you how to joust with these bandits. In the meantime, caution is advised as you enter the new epoch of uncertainty, a period of risk with no reward.



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