Hi and welcome to your October edition of Financial Independence.

Wow! October is already half over and another year is fast coming to an end. Last weekend, while doing the grocery shopping I noticed that Coles was already selling Christmas paraphernalia, which is a stark reminder of an impending shopping rush.

Many Inner Circle members have commented that we live in interesting times. I'd have to agree. We have certainly entered unchartered waters from an economic point of view.

The act of terrorism on America was certainly a shocking, cowardly and evil act - but in many ways the panic that has followed will do far more damage to the *world*. But it is in this environment that we will see a massive redistribution of wealth and I again fear that it is those that rely on salary or wage income to fund their lifestyles who will suffer the most.

Looking back on the concept of the 'Economic Clock' (see the March Hot Topic), I can see no evidence that would indicate that we have begun any sort of economic recovery. In fact, looking at the clock, I'd imagine that we are somewhere between 3 and 4.30 (be on the lookout for signs that moneylenders are becoming more selective about whom they lend to).

So it seems the worst is yet to come.

Higher unemployment (hence the comment about salary and wage earners), lower retail spending prompting staff layoffs at Coles Myer and store closures (Diamaru), warnings about likely falls in share prices and generally plummeting consumer and business confidence... in summary, doom and gloom.

But as I said at the Inner Circle Get Togethers and as David illustrated in the September Hot Topic, someone will make his/her fortune today regardless of the economic climate. The question before you is not "Where can I run and hide my head in the sand?" but "How can I position myself to take best advantage of the situation presented before me?"

Your opportunity of a lifetime may come soon - be sure you are poised to take action. If you haven't already done so, I strongly recommend you read the September Hot Topic and take appropriate action.

This month we'll examine:

- **Personal Wealth:** The psychology of success in times of doom and gloom.
- **Business Wealth:** Three strategies that will help ensure your business can ride out the recession rough times.
- **Property Wealth:** The art of making offers that flag you as a serious investor.

Let's get going...

Personal Wealth:
The Psychology Of Success In Times Of Doom And Gloom.

Earlier this month a close friend asked me to sit in on a portfolio review meeting he was having with his financial planner.

During the meeting the financial planner outlined the good performing stocks (of which there were few) and the poor performing stocks (of which there were many).

In the end, the bottom line twelve-month financial performance came out as a net decrease in the value of the portfolio of about $88,000 or 12% of the total portfolio value. The management fees charged by the financial planner were about $5,000.

You would think that I might have a few choice words to say about the poor financial performance, but what I was most shocked about was my friend's attitude towards the loss.

You'd imagine that he'd be upset at the poor performance of his portfolio and would be interested in asking about the change in strategy that the fund managers were employing in order to limit losses.

Yet he was far more accepting of the outcome than what I would have been if it had of been my money. My friend accepted what the financial planner said, which was the usual soothing words which are always uttered during the bad times, such as:

"You haven't lost until you've sold, and you're investing in the long-term, so ride it out and things will get better."

"Stocks go up and down in value. Look at the graph behind me that shows that over the *long-term*, your value is *sure* to go up!"

"Everyone has lost money - and if I may say so, your portfolio has still performed a lot better than some other clients that I have seen."

"Let's concentrate on the stocks that are doing well shall we?"

At one stage I was almost speechless when the financial planner suggested that some of the better performing shares be sold to fund the purchase of another investment. I asked "Why would you sell a food performing share rather than one (of the many) poor performers? Surely it's better to sell the dogs and ride the winners!"

But there was no reasoning to be done that day. The conclusion was to walk out with fingers crossed that the situation would improve before the next review at a time yet to be arranged.

I'm sure meetings like this are occurring all over town at the moment as financial planners, who earned commission during a time when everything went up in value, are now held accountable for stocks that under-perform in a market that is already declining.

At this stage of the economic clock, all personal investments should be reviewed in light of:

1. Control

It's OK to outsource the management of your portfolio to someone with more expertise, but you must be very careful to maintain control.

A key element of that control is setting performance indicators as to what you expect from your investment and that if these indicators are not met then you need to have some sort of *exit strategy* in place.

Investing for many people involves a lot of emotion and when it comes to making losses, no one likes to admit they made a mistake and may be a 'B Grade' investor.

Yet a large part of being a sophisticated investor is making sure you limit your financial risk by capping what is an allowable loss for the amount you have invested.

Perhaps the stocks will increase in value, but avoid 'hanging in there' and therefore risking more than what is prudent on the basis that "I'm in too deep now".

An example of an exit strategy might be:

Investment	Details	Exit Strategy
XYZ Mutual Fund Current Unit Price: $1.25	30,000 units invested at $1.50 per unit on 8/6/01.	If unit price falls to $1.00 then I'll arrange an emergency meeting with my financial planner. If unit price falls to below $0.80 then I will immediately sell 50% of my holding. If until price falls to below $0.60 then I'll immediately sell the remainder of my holding.

In times of economic uncertainty, it's those without a plan that will suffer the most.

2. Adopting A Long-Term Outlook Is OK, But...

Don't dismiss a loss as merely a glitch. It is **never** OK to simply accept a loss as part of investing.

Losses are valuable lessons. If you ignore a loss then you are very likely to repeat the mistake and make another loss!

Learn from your financial losses by trying to identify what part of your investment plan has gone astray (perhaps it's even a lack of a plan).

If you are using an adviser, then you should also make them accountable (or responsible) for their advice. Surely the best indicator of the skill of your financial planner is how s/he meets the performance objectives you set.

Perhaps consider your adviser as your employee. If you hired them and they promised to deliver but consistently under-performed, then how long would you give them (knowing it was costing you money) before you sought an alternative?

I think it is perfectly reasonable to judge your adviser by the value (or lack thereof) that s/he provides. Unless you make them accountable for the advice they give, then you probably deserve the results you are achieving.

3. Compare Your Investments To Industry Benchmarks

Even if you are a complete investing novice, you can measure your investment performance against what is being made (or lost) by monitoring what happens to the index of the market segment that you invest in.

If you are investing in shares then I suggest you use the "All Ordinaries Index" as the benchmark.

Property investors should peg performance to the "S&P/ASX 300 Property Index".

Both these indices can be monitored at: http://www.asx.com.au/asx/statistics/indexInfo.jsp

I suggest you keep a diary note of what the index was on the first day of each month and then measure the monthly change by calculating (index now - index one month ago)/(index one month ago).

Having this yardstick will again assist you to determine whether or not your investments are performing in line with their overall industry.

My friend made only one big financial mistake that day. He walked out of the financial planner's office hoping his adviser would have better news for him next year and keeping his fingers crossed that the decline in the stockmarket would correct sooner rather than later.

Summary:

Now is the time to develop a financial plan that outlines what your expectations are for your investments, together with performance criteria to measure any success or failure.
Part of your plan must include an exit strategy that identifies trigger points that will help you avoid being emotionally attached to your investment. Ignore taking action when your trigger points are activated at your own peril!

If you use an adviser, make them accountable for the advice s/he gives. The really good financial planners will make you money in good times... and bad times too!

If you're relying on the market to go up... keep your fingers crossed. Opportunities will arrive for you later rather than sooner. Smarter investors will create their own opportunity while the less sophisticated hope their advisers can turn things around.

Recession Proofing Your Business:
Three Strategies That Will Help You Ride Out The Rough Times

If you follow the theory of the economic clock then the next stage in our economic cycle will be 'tighter money'. What does this mean?

It may mean it will become more difficult borrowing money, since lenders are more cautious about whom they lend to, at the same time as requiring more security.

But of more immediate impact on businesses will be a squeeze on cash reserves arising more supply than demand, which will flow on to the capacity of a business to meet its debts as and when they fall due.

The first business casualties of a recession are those that have a poor or unreliable cash flow. To help you maximise your cashflow and secure a steady and reliable source of continual funds, I suggest you focus on the following three strategies:

1. Closely Define And Monitor The Distinction Between Business And Personal Expenses.

For many small to medium business owners the lines between what is 'personal' and what is 'business' become blurry, especially when many personal expenses are structured to be business-related to ensure they qualify as a tax deduction.

This is an appropriate strategy when cashflow is plentiful, but it is dangerous in less prosperous times. In short, consumption must now be monitored.

No longer can businesses spend money with an expectation that more business will arise to cover the cash outflow. I recommend classifying all expenses as either 'voidable' or 'unavoidable'.

Make it a rule to defer as much voidable expenditure as possible, while also be very mindful of limiting costs that were previously picked up by the business to a minimum. Put away the business Visa card (where the temptation is to consume now and pay later) and start writing cheques... the bonus points aren't as valuable as sound business practices.

Cash reserves will soon be extremely valuable. These reserves will be a tremendous asset when opportunities arise for your business to capitalise, while poorly run enterprises go to the wall.

Start preparing for a possible downturn *before* the need is urgent. You can start now by being prudent with managing your expenses as well as setting a cash reserve target for 31

December 2001. Use the table below to set the target and outline how you are going to achieve your goal.

My Targeted Business Cash Reserves At 31 December 2001 is:	$
This is how I'll achieve it:	

2. Understand Your Business' Cash Cycle

In all my experience as a Chartered Accountant, I know that the difference between a business that prospers and a business that struggles is how the cash cycle is managed.

Cash is your business' oxygen. When cash becomes tight, it becomes like someone who cannot get enough air - panic sets in and performance plummets.

As a general rule, the longer it takes you to convert sales into cash, the less efficient your business will be.

The length of time it takes to convert sales into cash is also known as the 'debtors' component of the cash cycle, which is best explained using the following case study.

Imagine that I run the XYZ consulting business. I usually bill monthly and offer terms of 30 days. I start a job on the 1st of October and complete it on the 12th.

By the time I raise an invoice (at the end of October) and it becomes due (at the end of November) I have waited 49 days.

Now if I had to purchase parts valued at $200 for the job and I had to settle the bill with my supplier within 30 days, I would have to finance (out of my own pocket) that $200 for at least 19 days.

They way most businesses finance this shortfall is from existing cash reserves or owner's equity. Where this is not possible then the alternative is to use an overdraft or line of credit facility.

If this is the way you are currently operating then beware - you are in poor financial shape.

An efficient business ensures that the time it takes to receive cash from debtors (people who owe you money) is less than the time it takes you to pay your creditors (people you owe money to).

I suggest you consider:

- The sales terms you offer vs. the purchase terms your suppliers offer. Aim to invoice immediately and look to defer payments to your suppliers where possible.
- If you have a business overdraft facility, then look to reduce the amount you owe as soon as possible. You will be better placed to survive with less debt and more cash reserves.
- If you don't understand the cash cycle concept, then seek the help of your accountant immediately.

3. Small Fish Are Sweetest!

My final point is to reiterate something David mentioned in the September Hot Topic.

In times of recession it is better to have many small clients rather than one big client. Diversifying your client base reduces the risk your business suffers should one of your clients go broke.

A good example is the catering company that boasted Ansett as one of its clients. In times of economic prosperity this would have been a major coup. Yet I read recently that when Ansett stopped flying, the company that provided the catering was forced into receivership immediately with debts of more than $20m.

Small clients may not make you rich, but they will be a secure and reliable source of ongoing cashflow. If you have been neglecting your smaller clients in the face of bigger opportunities, I suggest you rethink your strategy and start providing pleasant surprises for the customers that will keep your business afloat.

Summary:

Business success in times of recession is about money in the bank. Those with money are well placed to take advantage of opportunities that arise while other businesses with poorer cash management habits fold.

The time to begin preparing is before the crisis is upon you. In that regard I suggest all business owners set a cash reserve target to achieve by the end of December. If you need an overdraft facility to continue in business then be very wary that you are in a high-risk position.

Take the time to analyse your customer base and make sure that you remain loyal to your smaller clients who may not be the most profitable, but nevertheless place regular orders and can be relied upon in times of economic uncertainty.

Property Wealth:
The Art Of Making Offers That Flag You As A Serious Investor.

There are many pitfalls along the way to becoming a successful property investor.

One of the lesser-known pitfalls is they way you structure and submit an offer to purchase an investment property.

In order for a real estate agent to get paid s/he must have both a listing agreement from the seller and an offer to purchase from a potential buyer.

Not all offers are equal and the job of a successful real estate investor is to structure an offer in such a way that flags you as being serious, while at the same time ensures you can back away from the deal if needs be.

There are a five rules I follow when it comes to making offers:

Rule #1 Written Is Better Than Oral

In real estate terms, a written offer is always better than a verbal offer. In some States, the offer is made by actually signing a contract. Any counter offer is made by putting a line through the original offer and then writing a new figure.

It is a good idea to make written offers and provided you do it the right way, then you have nothing to be afraid of.

Rule #2 Always Include A 'Get-Out' Clause

This is where making an offer becomes an art form.

Your aim is to submit an offer that appears to be genuine while also allowing you a clause that you can call upon to exit if you have a change of mind.

If no contract has yet been prepared then the most simple and logical 'get-out' clause are the words "subject to the approval of the sale contract to the satisfaction of the purchaser's solicitor." If you have a change of mind, just have your solicitor disapprove the contract.

Other common 'get-out' clauses are:

Clause	**Effect**
"Subject to the purchaser applying for and receiving finance approval."	If no finance can be found then the purchaser can exit the contract.
"Subject to the receiving of a builder's report to the purchaser's satisfaction."	If you have concerns about the property then have a builder complete an inspection and if the outcome is not to your satisfaction, then just exit the contract.
"Subject to the approval of my business partner."	It is clauses like this that will have real estate agents take you for a fool. And in reality there is no need to use it because better (and more legitimate) get-out clauses exist.

Rule #3 Offer Price OR Terms

It should come as no surprise to you to learn that I think the key to your success is to create offers that give rise to a win-win outcome.

I believe the common practice of low-balling is a waste of time because although you win, the real estate agent and the vendor lose.

When I make an offer I make it known that I am flexible on price or terms, but not both. A large part of your success will come from only dealing with motivated sellers and by offering what it is they need.

If they need a large deposit or quick settlement, then the price will be adjusted accordingly. If they want full price, then they will need to offer something back to me to sweeten the deal, such as carrying back finance or long settlement terms with a low deposit.

When it comes time to negotiate, it becomes a question of what do you give and what do you take.

In one of our property acquisitions, we placed an offer of $30,000 and a sunset clause of 72 hours later. When we didn't here from the agent within the deadline, we just assumed that the offer had been rejected.

On the day after the deadline expired, Dave received a call from the agent confirming that the lowest the vendor would go was $31,500.

Dave mentioned to the agent that the offer had already expired, but in the spirit of fair play, we would extend the original offer until the close of business that day, with the price still at $30,000.

At 5pm the agent rang to let us know that the vendor had accepted the offer, subject to us agreeing to settle on the day that the vendor planned to take possession of her new house.

Despite being low on price, we still created a win-win outcome because the vendor needed to have cleared funds by a particular day - something we were able to do. While we weren't flexible on price, we were flexible on terms.

Rule #4 Include A Sunset Clause

You should always include a date when your offer lapses. This does two things:

- It ensures that the real estate agent begins working immediately and that you are not left in limbo or at the mercy of procrastinators; and
- Limits your exposure to having offers excepted when you have moved on to other deals.

Including a sunset clause ensures that you will be treated as a serious investor.

Rule #5 Sign Your Offer

The final rule is to sign the offers that you make. This demonstrates that you are serious and are not afraid to make a commitment - something that real estate agents admire.

Included in this months Financial Independence is a new PATTERN™ Template to help you make an offer that follows the rules I have described above. Access it by clicking the icon in the attachments column.

You'll note the template has two parts. The first is your record of the offer that you make and the second section is the written offer that you submit to the real estate agent.

The form is designed so it can be easily inserted into your due diligence folder. I suggest you keep expired offers in a separate location, as you may like to review the price you offered at a later date if a similar property interests you.

Summary:

When making offers I suggest you avoid the low-balling option at all costs. Instead, seek to create win-win outcomes by meeting the needs of the motivated vendor within the financial constraints of ensuring you end up with a cashflow positive outcome (ignoring depreciation benefits).

I encourage you to follow the five rules and implement the PATTERN template™ immediately. Remember... always work to create a win-win outcome.

If I had to sum up the state of the world economy right now it would be 'uncertain'.

It is a time for investors and business owners to review their financial health and to cast off any inefficiencies that will prevent them from capitalising on opportunities that are sure to arise, irrespective of whether we head into the depths of a recession or reclaim the economic bliss of yesterday.

Ask yourself one question:

If the opportunity of a lifetime crossed your path today,
would you be primed to take action?

Until next time remember, success comes from doing things differently.

Regards

Steve McKnight

PS. As always, I encourage you to continue to post questions and comments on the members-only forum.