

The Advanced Teachings of Mrs. Langerhorn: 01 **by Klarise Yahya, Commercial Loan Broker**

I hope my funeral was on a fine, sunny day and there were lots of people. I'm not a natural braggart, but when I think of all the folks I've helped over the years, well, I just hope you got a parking space! It's interesting to contemplate my death in advance of the occasion. I don't know what's on the other side, but I hope it's good. It would be such a shame if this was all there was, don't you think?

I remember how surprised you were when I taught you that if you could save 15% of your income you could be totally out of debt, including paying off the mortgage on your home, in less than eight years. I showed several people how to do that, and only you and one other young person ever actually did it. I'm very proud of both of you.

Once you became debt-free, you took the money you used to spend on credit card and mortgage payments and began investing in a good, low cost S&P 500 mutual fund and, later, fourplexes. That is not a minor accomplishment. Many people have become very, very comfortable doing nothing but following that modest little plan and repeating it again and again and again. Didn't you write a book about that? Called *Mitochondria Learns to Invest*, or some silly thing? I didn't teach you just so you could go and sell the information to others, but I hope the book did well. To my mind, teaching someone to invest is a priceless gift if they actually do it. It always amazed me that only a very few would follow the plan. Most just wouldn't do what it takes. Maybe there's some sort of predestination component to it. Those who were destined to wealth were probably helped. Your book hopefully made their way a little easier and those who were never going to have any money anyway probably read your book and just shrugged.

One of the things I wanted to do, before I passed, was to discuss with you how to invest at the next level. I know you took notes about fourplexes and mutual funds during our teas, but going to the next step up is a little different, and I wanted to walk you through the process ... but I just ran out of time.

I didn't know how to organize the data I wanted to give you. It troubled me a lot, because unorganized data is generally not very helpful. I know that. So I took your lead and wrote these notes in book form. I hope it works for you, but you have to understand that these last several years have not been good to me and I sometimes repeat myself.

Realize that, in these notes, I shall be rounding a lot of numbers. Additionally, I intend to paint with a broad brush. You will be learning more advanced investment concepts, but in almost every example there will be exceptions that nit-pickers will certainly seize upon. An example might be when I refer (as I expect to) to income taxes due on the interest payments from bonds. Right now – and it might change anytime Congress sits – it's possible to hold bonds in tax advantaged accounts. We understand that. But investing for tax benefits is not something we're going to discuss. I've never invested, and I hope you don't, in legislated investments that may be overturned at any time. One never makes long term investments on what may be only short term advantages.

And, of course, I can only share what I know. It's possible that everything that has made me financially comfortable these past 50 (plus) years will have become absolutely wrong by the time you read these words. I doubt it, of course, but you must still assume full responsibility for the results of your investment decisions. Use my guidance as only a starting point.

Philosophically, I support the classicist educational system as developed by Aristotle in his *Nicomachean Ethics*. Its distinguishing feature is the grammar – logic – rhetoric format.

Grammar is the period during which the student is force-fed (rather like a Christmas goose, I'm afraid) the basic building blocks of the subject. In mathematics it would be counting, addition, subtraction, multiplication, division, and so on. In the classic tradition, the student is not expected to have opinions during the grammar stage of instruction, as she lacks the information upon which to base an informed judgment.

The Logic tier of learning is where the student begins to recognize the internally consistent reasoning of the information presented in the earlier grammar stage.

The Rhetoric level develops as the student incorporates the consistent reasoning of the logic tier into her relationships with the larger world. At this point a student's opinions begin to be useful to others.

My late husband once told me that the U.S. Marine Corps, an organization he admired, followed the classicist approach in their training, but they called it "crawl, walk, run". It was, he said, much the same as the classicists approach but with perhaps a little greater glandular involvement. What immediately follows, then, is the Grammar stage of an investment education. These are the few but fundamental concepts upon which all investment is based. If you cannot digest them, you will never be able to intelligently converse with those who do.

Defining Investments

What are "investments"? Investments are purchases that provide *reasonable* assurance of the return **of** your money plus a return **on** your money. You must *reasonably* expect to (a) at least get your money back, and you must *reasonably* expect to (b) receive a net income during your holding period.

There are many things you could buy that might turn a profit, but are not investments. You could buy those terribly romantic Hudson River paintings, or cornflower blue untreated sapphires, or perhaps early baseball cards. You could buy gold, or oil futures or frozen pig bellies or options on the Turkish lira. All of these things may – it's not guaranteed, but they may – appreciate and you might eventually sell them for more than you paid. But even if they go up, they are collectables or speculations, not investments. *The defining characteristic of an investment is that it provides a stream of income.* None of those things I mentioned are investments because they don't provide a stream of income. Without this stream of income, as I'll discuss later, a purchase is simply not an investment because it's almost impossible to be even moderately confident of both the return **of** your investment and a return **on** your investment.

Getting the return **of** your investment and earning a return **on** your investment are not equally significant. It's much more important to get the return **of** your investment (*to not lose*) than it is to earn a profit (to get a return **on** your investment). The First Rule of investing is: *Don't Lose*. Why do you think this might be so?

Imagine, for example, you have \$200,000 in your investment account. Your nephew, the one with the suspect DNA, asks for an unsecured loan of \$100,000. Succumbing to intense family pressure, you reluctantly grant the request. He cashes your check and immediately declares bankruptcy. The rest of the family side with him, and you wind up writing off the entire sum. You just lost 50% of your investable funds. Now, what must you do to return to having \$200,000 in your account, to go from \$100,000 back to \$200,000? *You need a 100% gain to offset a 50% loss.* Losses hurt more than gains comfort. Ergo, the First Rule: *Don't Lose*.

Once you are really, really confident of getting the return **of** your money, it is then time to consider the return **on** your money. This will require a little arithmetic, but it's easy to follow so don't worry.

Given a fixed income stream, the return on your money is largely determined by how much you paid for the investment. Assume you buy a stream of income guaranteed to pay \$5 one year from the date of purchase. How much will be your yield (also known as the *capitalization rate*)? Well, that depends on how much you paid for the investment, i.e., the stream of income. If you paid \$100, you will be making 5%. ($\$5 \text{ divided by } \$100 = 0.05 = 5\%$). If you paid \$200, you will be making 2.5% ($\$5 \text{ divided by } \$200 = 0.025 = 2.5\%$). If you paid \$50, you will be making 10% ($\$5 \text{ divided by } \$50 = 0.10 = 10\%$). Thus, your return on your investment depends on how much you paid. Given the same net income, the less you pay the higher your yield. This is the formula that we use to find Yield: Net Cash Flow divided by Price equals Yield (in decimals). The Yield, as noted above, is also called the *capitalization rate*. Don't worry, we'll cover cap rates in greater detail later.

What if someone says, "This investment guarantees an income of \$20 at the end of one year. What is it worth to you today?" Well, its value depends on *your* required yield, on *your* capitalization rate. If competing investments, with similar risk profiles and similar time horizons, offered a 10% yield, then the value of that \$20 one year from today would be no more than \$200. The formula to find Price is: Net Cash Flow divided by Yield (in decimals) equals Price. Using this formula, what would be the value of this end-of-year (EOY) \$20 if you could get a 12% cap rate? It would be \$20 divided by 0.12 = \$166.67. Alternatively, if competing investments offered only an 8% return, the value of that \$20 would be \$250 ($\$20 \text{ divided by } 0.08 = \250). Clearly, the key to determining value is the capitalization rate you use. Assume you are occupying yourself in your normal daily activities, sitting there at the bar, and the bartender says "I know you own apartments, and thought that maybe you'd like to talk to the guy down at the end of the bar. He's trying to get rid of his building."

You begin talking with the prospective seller. He is slow to get around to the subject you are interested in, but eventually he does and you realize that the price he mentions seems dreadfully cheap. He claims the net income is \$200,000 per year, and he's asking \$1,700,000 for the property. You excuse yourself and go to the ladies room to plug the figures into your handy pocket calculator. You are being offered an apartment building at what appears to be a 12% cap rate ($\$200,000 \text{ divided by } \$1,700,000 = 0.118 = 12\% \text{ rounded}$).

You know that comparable buildings in the area sell for a 6% cap rate, making the value of the building close to \$3,300,000. The price is \$1,700,000 at a 12% cap rate; the market value is \$3,300,000 based on a 6% cap rate. What is demonstrated is that one way you can get very rich is buying at a high cap and selling at a low cap. *Don't get excited. This is just an illustration. It will never happen to you.*

Think of the relationship between price and yield (cap rate) as if they were on opposite ends of a see-saw. The fulcrum is the net operating income (NOI), and, for this example, it doesn't change. Now, if one end of the see saw goes down, what happens to the other end? It goes up. That's all you have to know at this point. *Price and yield move opposite to each other.* If price goes down, yield goes up. If yield goes down, price goes up.

Ok, so what have we covered here? The three elements of the investment "triangle" are (a) Net Cash Flow, (b) Price (or *Value*), and (c) Yield (*capitalization rate*).

If you have two of the elements, you can easily compute the third by either dividing or multiplying. Once again, the bullet points in this lesson are ...

- **Safety of your capital is more important than the possibility of high returns.**

- **If there is no income, it might be a speculative purchase or even a collectable but it is not an investment.**
- **If you have income, you can determine Price or Yield as follows:**
Net Income divided by Yield = Price
Net Income divided by Price = Yield
- **If you know Price and Yield, determine Net Income as follows:**
Price times Yield = Net Income

*Klarise Yahya is a Commercial Loan Broker. If you are thinking of refinancing or purchasing five units or more anywhere in the U.S.A., **Klarise Yahya** can help. **Find out how much you can borrow!** For a complimentary mortgage analysis, please call her at **(818) 500-9966**.*