

The Advanced Teachings of Mrs. Langerhorn: 02

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Time & Compounding

You know how to recognize financially illiterate people? You know them by the investment advice they offer. They say things like, *“It’s ok to take chances when you’re young. You have time to make it again. But you can’t take chances when you’re old”*. Sometimes they might advise, *“Don’t worry about investing now. You’re young. Wait until you make more money.”* Or, if they are really, really financially handicapped, you will hear them repeat mindless platitudes like, *“You have to take big risks to make big gains”*. An investor never takes big risks. Investors buy streams of income. Big risks, identified by the chance that you won’t even get your own money back, are a violation of Rule 1.

Let’s address some of these issues, in no particular order. Maybe we could begin by discussing why young people don’t have to take big risks to get big returns.

For our example, assume that you are 20 years old and expect to retire at 65. You have 45 years for your money to compound. Let’s explore some possible scenarios.

Scenario 1: You inherit \$25,000 from your recently deceased, and now favorite, aunt. You invest the whole amount in a good, low cost S & P Index Fund, compounding at 7% annually, net of inflation. How do we get this figure? Well, 10% is the historic long term return of the U.S. stock market (dividends reinvested). And inflation has, over the long term, averaged 3%. So our hypothetical 7% net return seems to be supported by historical averages. Just to keep things simple, let’s also stipulate that you pay neither costs nor taxes. How much will your \$25,000 grow to by the time you retire? Plug it into your financial calculator. You will have \$525,000, net of inflation, with little risk.

Scenario 2: You open a retirement account by putting \$2,000 into our stipulated low cost S&P 500 Index Fund. Two thousand dollars a year is \$5.48 per day. It is an amount you can manage. You add \$2,000 each year until you’re 65. How much retirement capital will you have? Your calculator will show you will have \$614,000, still net of inflation, and still with minimal risk.

Time doesn’t stop when you turn 65. You can continue to invest, of course. You could even invest small amounts for the benefit of your descendants, as in the following:

Scenario 3: You are not Peter Minuit, who purchased Manhattan Island from the Weekquaekeeks for the equivalent of \$24 back in 1626. You are the financial advisor for the Weekquaekeeks and you invested the entire \$24 in a hypothetical (hypothetical, because it didn’t exist back then!) S&P 500 Index fund. It has been there, compounding at 7% net of inflation, for 381 years. How much is the account worth now, in 2007? It is worth \$3,762,101,000,000. Three point Seventy Six Trillion Dollars and change. That’s bigger than a breadbox.

What we are establishing here is that if an investor starts young enough, she doesn’t have to take excessive risks to acquire sufficient capital to retire comfortably. If she invests long enough, as you may have noticed with the Weekquaekeeks, even modest amounts can accumulate to a tidy little piece of change.

Now, what about the mantra, *“You have to take big risks to make big gains”*?

Assume that you walk up to some fellow – anybody – on the street and offer them an investment that is guaranteed to double in the first year in exchange for a 50% loss the

second year. It's a two-year investment. Once you're in, you're in for the entire two years. There is no way you can leave the party early. Now, who do you think will jump on the opportunity you offer? All the financial illiterates will, guaranteed.

Let's spend a moment, you and I, and analyze the offer. Assume we invest \$100,000 and are locked in for two years. We know that we'll double our money one year and halve it the next, but we don't know the order this will happen in.

The first year, we gain 100%. We're up to \$200,000 and life is good. The next year we lose 50% and we're back down to our original \$100,000. Then the investment liquidates and distributes the proceeds, sending us a check for \$100,000. Isn't that great? Two years of "high risk / high return" and we're back to the starting line!

But wait. Maybe we'll lose 50% the first year, but then double the next. That's possible. But even then, our \$100,000 turns into \$50,000 then back to \$100,000. We've again invested for two years and haven't netted a dime.

In both these cases, the possible loss was limited to 50%. In a true high risk / high return offering, there is the possibility of losing our entire investment, and sometimes more if you're leveraged. If you get involved in any of the stupid high risk / high return offerings that are periodically available, you must accept the fact that to have your principal grow you must be right 100% of the time. If you're wrong even once, you can suffer debilitating losses.

Sometimes people will say, *"I'm young and not making much money, and I don't have the money to start investing this year. I'll start investing when I'm in my 40's and beginning my prime earning years!"* Let's examine this idea.

Once again, assume you invest \$2,000 a year from age 20 to age 45, then you stop. You make no additional deposits to your investment account. The account, however, continues to appreciate at our stipulated 7% per year. How much will you have when you're 65? You will have \$532,000, net of inflation.

If you start investing at age 45 and intend to make regular annual deposits until your 65th birthday, how much would you have to invest, at the same 7% yield, to get to that \$532,000 figure? You would have to invest \$137,000 (lump sum), or make annual payments of \$13,000. Remember that at age 45, although you will probably be entering your best earning years, your children will also be entering college. Your daughters will be getting married and want their tattoos removed. Your parents or parents-in-laws will be well into retirement and likely need financial help. "Prime earning years" may indeed refer to your years of increasing gross income while totally ignoring that those same years are also your "prime spending years". Your net income, after you meet your increased familial obligations, will probably be much the same. What does this mean? If you can't save \$5.48 (\$2,000 divided by 365) a day when you're 20, you probably won't be able to save \$35.62 (\$13,000 divided by 365 days) a day when you become 45. Don't put these things off ... they often never get any easier.

The bullet points in this lesson are ...

- **If you have time on your side, you don't have to take big risks to make big gains.**
- **By starting early and continuing for a long time, even modest investment amounts can compound to significant levels. Or you can start later and still wind up financially comfortable simply by simply investing past normal retirement age.**

- **It is very difficult to postpone your investment program and hope to make up for the lost time by making larger periodic investments.**

*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**.*