The Advanced Teachings of Mrs. Langerhorn #32
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Note to the Reader … These are not the notes of our conversations that were published earlier under the title "Mitochondria Learns to Invest". These are the papers Mrs. Langerhorn left me after she passed away. They are her advanced teachings, and as such they overlap and reinforce her earlier principles. I hope you gain from them as much as I did. The earlier lessons are incorporated in the book "Stairway to Wealth" available at LuLu.com

Dear Mitochondria,
We've talked about apartment investing for the past several years, and it occurred to me that there are some things we probably should review. In no particular order, then, these are the bullet points we've covered:

- **An investor buys various streams of income.** You can be either an investor or a speculator. Seldom can one person be both. It's a matter of mind-set, I suppose. A speculator buys something today and hopes to sell it for an uncertain profit in the indefinite future. There is a gambling exuberance that is unfamiliar to an investor who buys a known stream of income.

- **"Various" is important.** Anything can happen to a given stream of income, so it's important to be diversified. At the most basic level, all diversification means is that you have multiple profit centers. It can be as simple as buying a fourplex instead of a single family residence. You buy a single family residence and the tenant moves out, you have 100% vacancy. You buy a fourplex and someone moves out, you have a 25% vacancy. Diversification reduces risk.

- **"Stream of Income" is important.** There are only three things you can buy that will generate a stream of income: income properties; bonds, or stocks. Of those, bonds don't normally appreciate. A stream of income that doesn't appreciate means inflation erodes the principal. Bonds, consequently, are in my mind suitable only for the short term parking of money.

- Stocks tend to appreciate over time. The S&P 500, for example, was at 72.72 the end of July, 1970 (dividends were 3.46%) and grew to 987.48 at the end of July, 2009 (when dividends were 1.92%). While there were many ups and downs over the past 39 years, the overall growth of principal (not including dividends) was about 6.9%. That's not bad for an investment that permits you to make a one-time investment and then go back to sleep.

By the way, we used the S&P 500 instead of the Dow because the Dow includes dividends while the S&P 500 does not. If you're going to live off your dividends – so they are not available for reinvestment – the S&P 500 seems the more appropriate metric.

The S&P paid 3.46% in mid 1970, reducing to 1.92% by the end of July, 2009. You would expect the reduction because the S&P now includes many stocks that pay no dividend at all.

Because income property can be leveraged, it is likely the best overall investment as long as you're careful to have sufficient liquid capital for any emergencies. As an adult, you recognize that property values fluctuate, sometimes widely. The investor, therefore, buys the stream of net rental income generated by the tenants. Additionally, if one leverages the building(s), there is equity build-up, a very nice thing. For example, if you put 25% down on a building with a 15 year fixed rate, fully amortized mortgage … *and the value of the building never goes up* … you will make (if my memory serves) about 9.68% a year just in equity build-up. Plus the net cash flow. That beats the historical return of both stocks and bonds. Income property is probably where the majority of your investable capital should be employed.

Inflation: Inflation can be more damaging than taxes. The maximum tax rate can not exceed 100%, but inflation's potential rise is pretty much unlimited. Remember the Weimar Republic? In early 1921 the exchange rate was 60 marks per U.S. dollar. Two years later, on November 1st, 1923, a pound of bread cost 3 billion marks. A pound of meat cost 36 billion marks. And even that wasn't the worse inflation in recent history.

The Zimbabwean dollar recently inflated even more than the Weimar mark. According to the Central Statistical Office, annual inflation rate rose to 231 million percent in July 2008. The hyperinflation was caused primarily by the Reserve Bank of Zimbabwe's choice to mushroom the money supply.

But the record (so far) continues to be held by the Hungarian pengo. On Jan 01, 1927, the exchange rate was 5 pengo to one $1 (one US dollar). On July 31, 1946, $1 was worth 460,000,000,000,000,000,000,000,000,000 pengo. That's (4.6×10^{29}).

The point here is that the most you can be taxed is all you've earned. But inflation can take all you've ever made. Inflation benefits borrowers who locked in a fixed rate for a long term. For lenders, however, inflation is toxic.

As a great borrower, the government builds a degree of inflation in to the economy as a (a) counter to deflation and (b) compounding discount on any bonds outstanding. The more inflation eats away at the value of government bonds, the less the government has to pay back (in constant dollars). Consider the Weimar Republic. Assume a 120 mark Weimar government bond issued in 1921 ($2 U.S. equivalent). By 1946 they could retire truck loads of those 120 mark bonds for the same $2 U.S. Inflation strongly benefits borrowers and cripples lenders.

So during inflationary periods, lenders require ever higher interest rates. If you're a borrower, beware of variable rate loans.

Bonds don't normally adjust for inflation, but income properties and stocks typically do. That's an important consideration. In the U.S., we've not experienced hyperinflaction, but even our modest inflation numbers have a long term deleterious effect on wealth. Inflation between July 1970 and July 2009 was 452.18%. The annual rate averaged 4.48%. That means that what cost $1 thirty-nine years ago now costs $5.52. If you'd retired on a (at that time, splendid) fixed income annuity of $1,000 a month 39 years ago, it would be the equivalent of living on $181 now. Inflation counts.

But if you'd put $1 into the S& 500 back then and received 6.9% growth of your principal, the dollar you invested would now be worth $13.49. *You could have spent all the dividends freely while your net purchasing power more than doubled.* Kind of reminds me of Aunt Amanda's saying, "You can spill the milk as long as you don't kill the cow".

Or you might have put your money into income properties back in 1979 and just let the tenants pay them off. At a 9.68% annual increase over 39 years you would have turned $1 into $36.73 (not including any cash flow you received). That's pretty good, isn't it?

Have Adequate Liquidity. I've often been distressed by the number of investors that don't have much money – some not even 3% of their net worth – available for emergencies. If they had to enter the witness protection program, they'd be in deep trouble. Their excuse is obvious: "If I can do so much better in apartments, why would I ever put money into stocks?" Could I suggest a reason?

Can we agree that everything you own is insured? Usually, you pay a company to assume the (potential) liabilities of (your) ownership, but if you don't , you're not ***not*** insuring, you're ***self*** insuring. Liquid funds, money you can access without selling any of your buildings, is the capital reserved to cover your potential self-insurance obligations. Having sufficent liquidity means you are unlikely to have to sell one or more buildings at distress prices.

One of the richest women I know has half her net worth in income properties, one quarter in bonds, and the final quarter in blue chip stocks. She can do that because her concern is no longer in making money (although that diversified portfolio has done very well over the years, thank you very much), she just doesn't want to lose the money she has. By the way, her bond money is in Pimco Total Return. I asked her.

Most of the best investors I know have about 25% of their net worth in liquid accounts. A surprising number of them are not stock savvy so they just put it in the sort of low cost S&P 500 Index fund we've talked about before. While they may earn 9% (more or less, depending on the economic conditions of the time) in buildings, they might generate only 7% (more or less, depending on the economic conditions of the time) in stocks. The net cost is, in this case, 2% on 25% of your capital. That comes out, I think, to one-half of one percent (0.5%) of your net worth. It's insurance at a small price.

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