

Letters to Mycroft #37: Investment 501

Klarise Yahya

To My Dear Nephew, Mycroft,

Dromedary was having tea with Aunt Mitochondria, who still smelled like dried flowers.

"Auntie, you've taught me what an investment is. You've also taught me that with proper compounding, 'time' can make a person rich. Uncle Gustov has explained to me about 'leverage' and 'diversification'.

"Aren't I ready to invest, yet? What more can there be?"

"Oh, Dromedary, my dear, so far you've been learning *how to think* about investments. The first order of business is always to organize a young person's mindset.

For example, along the way you've learned that the average growth of the stock market over the last many decades has been 10 - 12% (including dividends). That is the return you can hope for in a liquid investment if you are properly diversified. The way you get rich is to let that 10 - 12% compound for a long, long, long time.

As you develop an investor's mindset, you will come to know that the seeds of wealth come from saving a significant portion of your income. When your savings accumulate sufficiently, you must invest in appreciating assets that generate cash flows. In that way your money begets money.

The worst thing that could befall you at this stage in your career is for you to suffer a windfall profit. Without fail, a windfall profit to a beginning investor would knock her right out of investing. We'll come back to this point at the end of today's Lesson."

"So what are we going to call this Lesson, Auntie?" Dromedary inquired, an innocent expression on her face.

"Don't be saucy, child! Neither Gustov nor I personally benefit giving you this education. But if you keep your ears open and your mouth shut, you just might learn something!"

"Sorry, Auntie. But really, what is today's theme?"

"Do you know anything about baseball? I once was seeing a gentleman who would come over here, sit in my best chair, turn on the TV to whatever ridiculous game was playing that day, and expect me to provide him munchies - he preferred salted almonds and Firestone ale. When the game was over, he'd arise, brush off the front of his ample torso, belch, and announce *"That was fun. We should do this again next week!"*

"Yuck! Why did you continue to see him, Auntie?"

"Well, you understand that the cost was playing barmaid while pretending not to be bored silly. It is a skill most women develop quite early in life. It was, after all, only one afternoon a week. But in exchange, I could see that my friends in the Ladies Bridge Circle were astounded that I could get *any* man at my age. None of them could. And when they asked why we stayed home every Saturday, I told them the truth. *"Well, I really can't discuss it. But you know what men are interested in. And sometimes he can do it for two or three hours at a time! Do you think it could be some kind of Tantric thing?"*

"You must always, Dromedary, tell the truth".

"But I learned a wonderful investing lesson from endlessly watching Saturday baseball on TV. I learned that games are won not by home runs, which are largely luck, although some players do seem to have more luck than others. Games are won by an endless series of one - two - and three base hits."

"Obviously, you need to keep your money fully invested. Don't stay out of the market, because it is almost certain that you will wind up with less money than if you had let your money work for you.

Save as much from your salary as you can. When you have enough to buy stocks (or mutual funds), do so. When your assets grow to the point that you can buy small income properties, do that.

Very soon, you will have both stocks (or mutual funds) and income property. You will be fully invested in the only two asset classes that traditionally appreciate over time. Your money will be working for you. Eventually, you won't have to work ... because your money does.

The basic rule is that in an efficient market, everything that could be known about an investment, is known. Since all known data is already factored in, you must understand that the

buyer will always buy at full market price. You make your money either by (a) buying an index of stocks and letting the growth of the market increase your wealth, or (b) buying stocks that are going up and hope that they continue, or (c) taking a position that is contrary to the balance of the known data.

An example of possibility (a) would be if you invested in a low cost S & P 500 Index fund and just let the upward trend of the market take you up the mountain. An example of item (b) might be Hovian Enterprises (HOV), which rose from about \$50 a share in August 2003 to over \$75 within the following 90 days. When the stock dropped, somebody was left holding the bag. The final example might be Vodafone Group (VOD), which, based on known data, reflects a \$21 price. But some people think VOD may very well go to \$40 over the next three or four years. Yes another example is Pfizer (PFE), which the known data prices at about \$30, but might have a reasonable expectation of doubling in the next 3 or four years.

There is a type of stock purchase which doesn't fit into any of the above categories. It is not an index purchase. It is not a momentum stock. There is no free cash flow, so it's almost impossible to forecast its value. This type of stock purchase is pure speculation, and you have a reasonable chance of losing your delicate items. An example might be American Technology Group (ATCO). This is a highly volatile stock currently less than \$5. If things work out, there's no telling where it might go. But it's not even making a profit right now and there is a reasonable chance ATCO could just drift sideways for a while before becoming road kill. In that case you would lose your entire investment.

Whether you buy VOD or ATCO or any other asset, you will be paying full market price. You will be paying more than any other sane person is willing to pay for that asset at that moment in time. After all, if someone else would pay more, why would the seller accept your bid? *You pay top dollar, but you expect the value to increase over time because you hope the net cash flow generated by the investment will trend upwards.*

If you are right, you win.

It's the same with apartment buildings. If you buy a little four, or even 10-unit building, you will pay more for it than anyone else is willing to pay at that instant in time. You make your money because you expect the building's value to trend upwards over time.

Then you do it all over again.

These are the single, double, and triple base hits we've been looking for. You pay full market value for an appreciating asset, then go back to sleep.

It would be disastrous if the first stock you buy at \$30.00 rockets right up, completing the year at \$90.00. Sure, you would have made 200% on your money but *you would never invest again!*

When a young investor makes such an early windfall, it is natural that she will want to duplicate it. She will no longer invest unless she is absolutely certain that she can make at least the same 200% a year. *And it never happens! She wasn't certain with the earlier investment (or she would have invested every penny she could raise, even if it meant selling the farm) and she can never be absolutely certain in any future investment.* So she spends the remainder of her life endlessly sitting on the sidelines, waiting for Godot, and dies a pauper. Even though she got a home run, it happened in an early inning and she lost the game."

"But Auntie, I've heard of people who bought Microsoft when it first became public, or people who bought an apartment building dirt cheap! What about them?"

"You miss the point. When shares in Microsoft first became available, nobody would buy them for a higher price ... or they would have sold for more. It was what happened after the initial offering that supported their growth.

Do you think you are the first person who ever heard of that hypothetical "cheap" apartment building? Of course not. The brokerage community knew about it. The lender was aware the building was in trouble. The tenants knew most of the units were vacant. The girls at the Department of Water & Power wondered why the owner was behind on his utility bills. You are just the poor schmuck that bought it.

In any event, *you paid full market value* for a disreputable building that would shame any self-respecting slum. It was only what happened *afterwards* that determined its ultimate reputation. If you turned the building around, it will seem in retrospect like a good deal and you will boast endlessly. If you are just another owner of a serially foreclosed building, you will never mention the unfortunate purchase again.

"The point stands. Miraculous purchases are visible only in retrospect, when everybody can see them. To win the game, the investor needs only to keep fully invested in reasonable assets, *purchased at full market value* that she expects to grow over time."

"So the mindset I should have is to make many small investments (that way I get a lot of opportunities to learn!) and expect to pay full market prices. If I have enough investments, even a total loss of any single item won't be catastrophic. And I should not swing for the fence, but try for consistent, modest gains? Do I have that right?"

Cordially,

Aunt Klarise

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**.