

Letters to Mycroft #40:

Investment 801: The Most Important Number

By Klarise Yahya

To My Dear Nephew, Mycroft:

*“Aunt Mitochondria, is there anything about investing that I should have asked, but haven’t?”
Dromedary inquired.*

“Well, dear, we’ve discussed the necessity of having an Investors Mindset. We’ve established that before something can be an investment, it must generate a Cash Flow. We’ve illustrated the importance of Time ... the longer you can keep your money compounding, the more it’ll grow. You’ve learned to be properly Diversified, which means that any given bullet shouldn’t hit all of your investments. We discussed Leverage, which is how you control a large asset with only a little of your own money. You know about how the game is won by a Consistent Series of Small Gains (*remember, each gain compounds the one before*). And I think we also mentioned that it is always nice to buy below Central Value, if you can.

“By this time, you should be a lot more prepared for a lifetime of investing than most of the folks out there whose idea of the best place for money is a pair of Jimmy Choo shoes!

“Here, however, is something you might wish to keep in mind. It is just a little sophisticated, but it defines the difference between amateur investors and the professionals.

“The most important difference between folks that eventually become merely comfortable and the ones that become really, *really* rich is this: It is the difference between Return on Investment (ROI) and Return on Equity (ROE).

“These two numbers are frequently used interchangeably, as though there were no differences between them. In fact, one number reflects the result of an historical decision and has no real present utility. The other number generates current data that you can use to improve your future investment results.

“There is only one moment in time when ROI is the same as ROE.

“Let’s say you put \$25,000 down on a \$100,000 property. At the end of the first year, your property has appreciated to \$110,000. You have made \$10,000 on a \$25,000 investment. Your ROI is 40%, and your ROE is 40%. *The only time they match is at the end of the first year of the new loan.* After that, ROI tends to go up, and ROE trends downward.

Return on Investment

“Jumping ahead to the end of the tenth year, if your property continues appreciating at 10% per year, it should be worth about \$260,000. If it again goes up 10% in the eleventh year, it will be worth \$285,000.

“Your ROI that year will be \$25,000 (net appreciation in year 11) divided by your original investment of \$25,000. It comes to 100%. If only that number were useful!

“New investors, Dromedary (*and some investors never really get dry behind their ears. They might have been investing for thirty years, but that just means they have one year of experience repeated 30 times*), are fascinated by an incredible ROI number that rises from 40% the year of purchase to 100% eleven years later.

“The fact is that ROI is an historical number that is useful only for bragging rights when your chauvinist pig brother-in-law comes to dinner. It does not reflect what is happening now.

“The disturbing thing about ROI is that the longer you keep your investment and the more equity you accumulate, the greater your Return on Investment appears to be. It seems convincing, but it’s based on an ugly error of perception.

Return on Equity

“Here is how committed investors view the matter. ROI doesn’t give them target lock. They are focused on how much of their equity is required to make the next year’s gains.

"In the prior example, at the end of the tenth year, you had \$185,000 (\$260,000 minus your loan balance of \$75,000) of equity tied up just to make the \$25,000 in year 11. Year 11 gains divided by Year 10 equity means that you're only making 14% ... on your equity.

"All a real investor cares about is compounding her Return on Equity. She wants her ROE to be as high as prudent. That, Dromedary, is how small sums grow huge.

Conclusion

"Isn't there any way to keep your ROE high?" Dromedary was curious.

"Of course there is. It's very simple, and the really sophisticated investors do it all the time. The way to keep your ROE high is to regularly refinance. It is as simple as that. When you refi, you pull out as much of your equity as you can. That reduces the amount of your money you have remaining in the investment, and at the same time maximizes your ROE.

"For example, go back to our hypothetical property that has appreciated to \$260,000. Assume we refinance for 75% of value. Immediately, the equity that remains in our building drops to \$65,000. Now, if the building appreciates \$26,000 (10% of \$260,000) in the next year *our ROE is back up to the same 40% it was in our first year of ownership* (\$26,000 divided by \$65,000).

"So the first benefit from refinancing is that we regain maximal Return on our Equity.

"The second benefit is that we've pulled out a lot of cash (in this case, \$120,000) and we have to find some place to put it.

"What better place to put our cash-out money than to buy another, bigger income property?

"Look at what we've done, Dromedary. We've kept our first building and bought a second one. We have regained our original high ROE on both buildings. *We are using the equity in one building to buy another!*

"And that, dear, is how folks use financing to become really, really rich. They regularly refinance to keep their ROE high and they use the cash-out proceeds to buy bigger and bigger properties.

Colloco, Ergo Sum,

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.