

**Mitochondria Learns to Invest #06**  
**By Klarise Yahya, Apartment Loan Broker**

***Continued from last month ...***

"There are", Mrs. Langerhorn began, "fourteen declinations for Spanish verbs, excluding the progressives. But a person can get along quite well with only three: the past, present, and future tenses. Similarly, there are an unwieldy variety of ways to justify making an investment. Every financial commentator seems to have developed their own. But there are only three that you need to know about, and only one that is useful.

Just because a purchase goes up in value does not make it an investment. Prices can go up or down for reasons *other* than their stream of income.

"**Value in Us**" reflects the utility you project into an item. It explains why one collector of vintage penmanship will pay more for a Louis Madarasz letter than they might for an F.B. Courtney, but someone else will do the opposite.

"**Speculative Value**" is what happens when you buy an item hoping to sell it for an unknown profit sometime in the indeterminate future. A speculator can never be sure of his profit nor of his holding period. Speculative profit comes at sale.

"**Investment Value**" comes from the stream of income. That's what investors buy." Mrs. Langerhorn looked at me a moment, then continued "I can't make it any clearer than that. Investors buy various streams of income."

There was a long pause. I was incredulous. "That's it?"

She put on that odd face she assumed whenever she had fresh doubts about me. I was familiar with the look from back when we discussed the mortgage interest deduction.

"That's it. Streams of income", she said. "But there are some housekeeping issues we have to deal with before we can proceed. We have to talk about and dismiss some of the things people consider investments.

"First, *just because it's a major purchase does not make something an investment*. For example, gold is not an investment".

"But I hear on the radio all the time that gold *should be part of every portfolio!* I objected.

Mrs. Langerhorn continued, "Gold is scarce. All the gold ever mined in the history of the world would fit into a cube not much more than 20 yards on a side. It could fit in your front yard. But scarcity by itself doesn't make a good investment. For example, the price of an ounce of gold was \$892 in 1980. Today, twenty five years later, it's at \$426. How can something be a good investment with that kind of record?"

"It's not just gold. Precious gems are not investments, either. Colombian emeralds sold for as much as \$30,000 a carat in 1990. In 2000, they were selling for \$10,000 per carat. Now, in 2005, it's between \$300 and \$400 a carat.

"We can stop here. The point is made. Just because things might be expensive or scarce doesn't make them an investment ..."

I interrupted. "But what if somebody buys gold at today's price and it goes back to \$892? Or if they buy emeralds at \$400 a carat and they go up to \$10,000 or more? Wouldn't that make it an investment?"

"No," she said. "An investment must give you a stream of income during your holding period. If it doesn't, it's a *collectable* not an investment. Your home, for example, is usually not an investment ..."

"But everybody says it's the most important investment you'll ever make!" I interjected. "And all my friends who have homes talk about how much they've gone up!"

"Your own home does not give you a stream of income", Mrs. Langerhorn said. "In most markets you cannot rent a recently purchased single family home for enough to pay for the mortgage interest, taxes, insurance, and maintenance. Most people who buy a house for rental purposes wind up subsidizing their tenants for several years. Basically, you can usually rent somebody else's house for less than it would cost to own your own."

"Then why," I asked, "do people make so much money buying and selling homes?"

Mrs. Langerhorn looked at me over the top of her glasses. "Once again, just because a purchase goes up in value does not make it an investment. Prices can go up or down for reasons *other* than their stream of income. Remember *Value in Use*? If you insist on buying a house whose total costs of ownership will be greater than its fair rental value, it might be best if you purchased in an area offering valuable non-economic amenities. You might buy close to the beach. Or you might buy in an area where development is restricted but whose magnificent school system continues to draw new residents. The rent still won't cover the costs of ownership, but your speculation might nevertheless do very well in the end."

I'd heard about buying your own home for so many years that I just wasn't ready to let go. "But if you buy a house, can't you at least say that its income is at least equal to the fair rental value?" I was starting to talk like her. "After all, a person has to live somewhere!"

Mrs. Langerhorn didn't hesitate. "If fair rental value exceeds the sum of interest payment plus taxes plus insurance plus maintenance then you could argue that you were indeed buying your house and getting a positive cash flow on the purchase. Of course, one almost never sees this but I suppose it might occasionally be possible."

"The important thing for us to agree on is that *investments provide a stream of income*. If a home costs you more than its fair rental value – in other words, if the costs of ownership exceed its current income – the property does not rise to the level of an investment."

I was pretty much speechless. I'd heard all my life that the best investment anyone could make would be to buy their own home. Now, this woman was telling me that houses were not investments unless they immediately generated a positive cash flow. I didn't know if I really accepted this concept, but it wasn't the hill I wanted to die on, at least until I'd thought it through some more. I pushed on.

"So if a home isn't an investment", I asked her, "What would be?"

"There are only three things", Mrs. Langerhorn said, "that are investments: bonds, stocks, and income property".

I almost screamed. "But you just said that real estate wasn't an investment!"

"I said that properties that do not generate a positive cash flow are not investments. Obviously, properties that do give you a cash flow can be very excellent investments. Must I remind you that I've been cashing your rent checks for several years?"

"So if I could buy property that gave me a positive cash flow right from the close of escrow, then that would be ok?"

Mrs. Langerhorn looked at me strangely. "Of course", she said. "That's what we've been talking about".

After a moment, she continued, "So income property is one of the three things that can qualify as an investment. The second thing is stocks. When you own a stock, you have an actual ownership interest in a business. I think it's often best to start with dividend paying stocks in well established companies. Most people consider the dividend as their cash flow.

"The third thing you could invest in would be bonds. Bonds are debt instruments. If you lend money to a company, they give you a note (bond) as evidence of the debt. The interest on bonds has to be paid before dividends are paid on stocks, and many people like the security that brings. Bonds are normally sold in \$1,000 increments and are typically available through your stock broker."

She paused and I used the opportunity to ask her, "What do you invest in?"

"I buy stocks and income properties. I almost never buy bonds, even if their interest rate appears enticing."

That surprised me. It seemed to me that bonds would be like really safe, high interest savings accounts. "Why don't you buy bonds?" I asked.

"There are two components to interest rates. First is the risk-free rate, which is determined by the U.S. government issue of similar duration. I'm a long-term investor, so I use the ten-year Treasury issue as an indicator of the risk-free rate. It's considered risk-free because you know the government is going to pay you when the note matures. If it has to, it will just print more money.

"Assume the ten-year Treasury is paying (and I'm just going to make this up) 8% and you are offered a corporate issue paying 10%. What that means is that the market is assigning 2% of risk premium to the corporate note. The market is saying that if you bought enough corporate

obligations of that quality from enough different companies, you could expect sufficient defaults that your achieved interest rate would net out at exactly the risk-free Treasury rate of 8%.

I interrupted. "So you're saying that after deducting for greater risk, you can't expect a corporate bond to pay more than the Treasury of equivalent remaining life?"

"That's right. But it gets worse. You know that 10% corporate bond you're offered? Well, you have to pay taxes on the income. Say you are at a combined State-Federal tax bracket of 40%. Then forty percent of your bond interest goes right to the tax guys. Forty percent off of 10% brings you down to 6%. But we're not through yet.

"If inflation consumes 4% of your principal every year, then the interest yield on those hypothetical corporate bonds after deducting for taxes and inflation is only 2%. It takes a long time to get rich at 2%." Mrs. Langerhorn sipped her tea.

"It might be okay to initially net a 2% cash flow if it increased over time, but bonds don't. Whatever interest you get when you buy the bond, that's the interest you'll be getting during the entire holding period."

"Then why do people buy bonds?" I asked.

"There are some exceptions, but normally people buy bonds to maintain wealth. They do not buy bonds to increase wealth."

"But don't bonds pay more interest than stocks pay in dividends?"

"Usually they do," she replied. "But bonds don't generally go up in value. Stocks and income properties do. Stocks and income properties are the only two investments that, over time, trend up in value. That's why I buy them.

"You see", she continued, "growing wealthy isn't rocket science." She took a bite from her shortbread cookie, then smiled and added, "Dumber people than you have done it."

It was just like Mrs. Langerhorn to be so encouraging. Actually, I thought I was starting to see a dim light at the end of the tunnel, but I wanted her to amplify it.

"Could you just reduce our discussion to a sentence or two? I think I'm starting to understand, but it's not really clear yet" I said.

"Well, we wouldn't even be having this discussion if you weren't out of debt and living beneath your means. But now you are ready to go to the next step. Briefly, here it is: *Investors buy steams of income. If you wish your investments to grow, you will purchase only stocks and income properties because they are the only investment vehicles whose values trend upwards over time.*

"That means that the longer you hold them, the more cash flow you'll get?" I asked.

"Yes. But it also means something else, something very important to a Young-Investor-In-Training". She smiled again. "It means you don't have to spend your life gutter sweeping for under-priced investments. It means that you can buy stocks or income properties at full market value and still expect them to generate increasing cash flows in the years ahead.

"That's important, because to be financially independent you have to have *cash flow*. Only cash flow lets you live well. No cash flow, no investment. Is that acceptable to you?"

"I understand", I said.

"The next point is a corollary. It is this: *the income determines the value.* Everything else being equal, which has more value, an income of \$10,000 a year or an income of \$25,000?" Mrs. Langerhorn was looking at me like she wasn't absolutely sure I would get this one right.

I let her sweat a moment. I tried to put a bored look on my face. "Obviously, the \$25,000".

"Correct. So now you know that (a) investments provide a stream of income and (b) high income streams are more valuable than low income streams. Do you know how few people in the world understand even those two fundamental characteristics of investing? I am truly proud of how far you've come!" Mrs. Langerhorn beamed.

I quickly took the bored expression off my face and pretended it was never there. "But I still don't know how to invest," I protested. ***Continued next month ...***

*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.*