

## **Mitochondria Learns to Invest #11**

**by Klarise Yahya, Apartment Loan Broker**

Continued from last month ...

Mrs. Langerhorn took her accustomed seat and peeled her teabag out of its envelope. "Not every bit of conventional wisdom is totally wrong", she began. "Some of it is only partially wrong. For example, most financial planners advise putting a portion of your portfolio into bonds and a portion into stocks. The exact ratios may differ between consultants, and an individual planner can even change his recommendations as his client ages. Generally, the older the client, the greater the portion devoted to bonds.

"Now, we discussed in one of our earlier meetings how bonds are best used to maintain wealth, not to increase it. That's why older people, who recognize that they can't afford to lose money because they don't have enough time left to make it back, tend to gravitate towards bonds. While bonds can't materially improve their wealth, at least the old folks aren't taking excessive risks with what they have.

Over long stretches of time, the stock market has returned between 10% and 11% a year (including dividends). Using the Rule of 72, at a 10% annual yield, your money doubles about every seven years.

"But you're not yet that old", she smiled. "so bonds probably aren't for you. You need your liquid assets to grow. Bonds don't normally grow. Stocks normally do. If you have the time and interest to invest in individual stocks, you probably should. If you recognize the need to be in the stock market, but aren't a "stock" person, you should consider mutual funds.

"I read one time that there are now more stock mutual funds than there individual stocks. That may very well be true. There are so many mutual funds that it's hard to select among them, particularly when most of them don't even match the market.

"You see, mutual funds have a great deal of money to invest, but they can legally invest only a small portion of their assets into any one company. Consequently, they wind up buying shares of so many corporations that the fund begins to mirror the marketplace.

"That's not a bad thing. Remember the Rule of 72? Over long stretches of time, the stock market has returned between 10% and 11% a year (including dividends). Using the Rule of 72, at a 10% annual yield, your money doubles about every seven years.

"So you've got money in a fund that, buy its sheer size, tends to mirror the market. That means that if the market goes up 10%, the gross value of the fund goes up 10%. But now you have to deduct the costs of running the mutual fund. A partial list might include management fees, administrative fees, and buy / sell commissions. Moreover, there are fees charged present clients to allow the fund to advertise for future clients. In addition to fees, the funds normally have high turnover rates (few stocks are held more than one year), resulting in unfavorable tax consequences to fund shareholders.

"So there you are. While your fund may come close to matching the market, you have to deduct fees and costs. That is a huge burden. If fees and costs come to 2%, then a fund that is so large that it effectively mirrors the market has to do 25% better than the market (10% divided by 0.8) just so the net increase to the shareholders is equal to the market.

That is an extraordinarily high hurdle. The result is that probably 75% of stock funds don't do as well as the market itself. And the small portion of Funds that, each year, beat the market are not identifiable in advance. A market-beater this year may very well be a laggard next year. Thus, I like to suggest that most investors put at least a portion of their liquid funds into a low-fee Standard & Poor's 500 Index fund. This sort of fund owns shares in the 500 largest publicly traded companies in America. It pretty much tracks the American economy, but the costs of an Index fund are supposed to be minimal ... and that is its advantage. After netting out costs, an Index fund's returns are usually much closer to full market returns.

“Here is one way to think about a mutual fund that has a very low expense ratio and whose job is to track the market. The question is, if there were a way to almost guarantee that your stock account would beat most of the professional money managers, and was tax efficient, but in exchange you had to accept that your fund would never be the best nor the worst performer in any given year, would you accept the tradeoff? Most people would. I know I would. Well, these are some of the characteristics of an S&P 500 Index fund. The index has very low turnover, so any mutual fund that copies the index is automatically tax efficient. And the costs are usually very low. At last, one S&P 500 Index fund has annual costs of less than ¼ of one percent. That means it costs you under \$250 a year to professionally manage a \$100,000 portfolio. As a reference, a fund with a 2% expense ratio would charge you \$2,000 to manage that same \$100,000.

“To repeat myself, you must understand that an S&P Index fund approximately mirrors the market, pretty much like any big fund. Its advantage is not in stock selection. It is in having a low fee structure. Excessive fees are brutal. If the market goes up 10% and you are charged a 2% expense ratio, your net return is 8%. Ten thousand dollars invested at 8% grows to \$68,000 in 25 years. But, if you paid lower fees and netted 9.75% annually, at the end of 25 years you would have \$102,000. That’s a 50% difference, just by being careful with fees.

“You probably should have a portion of your liquid money in the stock market. But it’s not because that’s necessarily the best source for growth. You could possibly get better growth elsewhere. It’s because prudence requires that you have some funds that you can get to very quickly, if the necessity arises. Instead of keeping all your money under the mattress, you put them in stocks because you might as well get some kind of growth for your trouble.

“It’s important to repeat that at this level we don’t keep stocks for capital gain, we kept money in stocks for liquidity.”

I’d been noticing something in her conversation. She kept using qualifiers when she talked about stock mutual funds. She would say, “some” of your money or words to that effect. So I interrupted to ask her a question.

“How much of your money do you put in stocks, and where does the rest of it go?” She didn’t hesitate. “I keep a little cash under the mattress. The rest is investment capital. I try to keep 25% of my investment capital in stocks. The remainder is in income properties. Remember that 14% you needed to earn to retire comfortably? You get it in apartment buildings.” *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.*