

Mitochondria Learns to Invest #07

By Klarise Yahya, Apartment Loan Broker

Continued from last month ...

Mrs. Langerhorn reached for another shortbread cookie. They seemed to be her favorites, so I put them on the table whenever we had tea. She only ate two each time, so a box lasted a long while.

“Before we proceed to some of the tools of investing”, she began, “There is a concept you must internalize. You must accept the principle of *incrementalism*, which comes in two forms. Mr. Langerhorn could say it better than anybody. He used to say that before you invest, *you must be able to take the hit*. That is the first element, and it simply means that you must never invest in any given project more money than you can afford to lose. Our limit, for many years, was five percent. We never put more than five percent of our net worth into any single investment. That doesn’t mean that we had twenty investments. During our early years, we had only two or three investments. Most of the time we had almost all of our net worth, as small as it was, in cash or cash equivalents like certificates of deposit.

“The second element of incrementalism is that, like baseball, *investing is a game won by singles and doubles*. True investors make very few home runs, simply because there is too much risk in regularly swinging for the fences.

“Assume for a moment that you have \$100 invested in a high risk enterprise. It goes down, and after great effort you recover only half of your investment. You now have \$50 to reinvest. Do you realize that you have to double that \$50 just to get back to where you started? Remember this: ***it takes a 100% gain to offset a 50% loss.***”

“So let me get this right,” I said. “You want me to get rich by taking small positions in low yielding investments? And for this I give you shortbread cookies!”

It was the first time I ever heard Mrs. Langerhorn laugh. She raised her glasses and dabbed the corners of her eyes with a paper towel, careful not to smear her makeup. She was still chuckling when she answered.

“I told you a long time ago, back when you were still learning to live beneath your means, that most people never achieve wealth because to become wealthy you must reverse your normal spending behavior. Do you recall?”

I remembered. “But how can you become rich like that?” I asked.

“Time”, she said. “When you’re young, time is your greatest investment friend. When you’re old, it’s your greatest investment enemy.

“The value of time is that it permits your money to compound. When you invest, you expect to earn interest on your money. If you spend the interest, your principal never grows. And, consequently, your annual interest payment never increases. For example, let’s say you invest \$100 at 6% and receive \$6 a year interest. If you spend that \$6, the next year you still have only \$100 to invest and your end-of-year-two cash flow will remain at \$6. If you keep spending that \$6, at the end of 300 years you will still have only \$100 of principal invested. And it will still be making \$6 a year.

“But if you could leave the first year’s \$6 in the pot and, next year, get 6% interest on \$106 then you would earn \$6.36 that year. When your money compounds, it is making money on the accumulated interest. If you continue to leave your interest payments in place year after year you can become rather well off. At the end of 300 years you would have a little under four billion dollars (\$3,906,245,905 to be precise).

“Here is another example. You may remember from your schooldays that Peter Minuit purchased Manhattan Island from the Weekquaakeeks for the equivalent of \$24. That was in 1626. Many people consider it a favorable purchase.

“But \$24 was committed for 379 years. If that same \$24 were invested at a compounded 10%, it would now be worth \$116,960,400,000,000,000. There are folks that believe the entire present worth of Manhattan, including all infrastructure, buildings, and contents is not worth almost \$117 *thousand* billion dollars.

I was slack jawed. How could so little money turn into so much? “He must have cheated the Indians!” I told Mrs. Langerhorn.

“Actually, dear, he probably paid full market value. Market value is the *‘estimated price a willing buyer would pay and a willing seller would sell, if both were fully informed and acted intelligently and voluntarily’*.

I remembered that definition from a class I took a long time ago. If Mr. Minuit didn’t pay full market price for Manhattan Island, at least the Indians must have thought he did, which is close enough. “There is no indication that the purchase of Manhattan Island was other than a market related transaction. Mr. Minuit did not take advantage of the Indians. The Indians did not take advantage of Mr. Minuit. The lesson here is important: *you can get very rich by paying full market price for an appreciating investment and keeping it for a long time.*”

Mrs. Langerhorn heavily emphasized her last sentence, so I suspected it might be important. Her statement, however, brought up two questions. I asked her the first one.

“What is an appreciating investment?” I said.

“An appreciating investment generates increasing cash flows over time. We don’t consider things whose values, but not its income, go up as appreciating investments. You need cash to live on, so we’re only interested in increasing cash flows. After all, which would help more to pay your living expenses, a \$100,000 investment that goes up 10% a year but has absolutely no cash flow, or a \$100,000 annual cash flow that goes up 10% a year?”

“I may have mentioned this before, but there are only two investments whose income streams trend upwards over time: stocks and income properties. If you pay full market price for a diversified basket of dividend paying common stocks – I’m thinking of an appropriate low-cost mutual fund – or a well located apartment building, you can do very well just by keeping them long enough. Over time, both dividends and rents tend to go up.”

“So why do you emphasize buying at full market value? Isn’t it better to try to get a bargain?”

“It’s normal for a new Investor-in-Training to have greed generated fantasies. And there are people who prey on this. You’ve seen infomercials or ads in the Sunday paper offering to sell you a course in getting rich quick. The dangerous thing is that every once in a while, someone really does succeed in stumbling into a windfall. But most people don’t. What I am teaching you is not how-to-get-rich-suddenly. I am trying to show you how-to-get-rich surely.

“I know this will sound counter-intuitive, but the very worst thing to befall a New-Investor-in-Training is to make a ton of money very suddenly. An example would be to buy stock in a company a week before it discovers the cure for aging.

“You know what happens after an unexpected windfall? You will probably never make another investment. For the rest of your life, you will be holding your breath waiting for yet another miraculous purchase. After all, it happened to you once and maybe it could happen again. But it never does. So instead of taking advantage of all the market-related opportunities that are regularly available, our windfall-girl waits for a second perfect opportunity. It never happens, and

ultimately she dies much poorer than she might have been. The perfect, after all, is the enemy of the good.

I had another question that just popped into my head. "Earlier, you referred to a 10% return. Why did you pick that number?"

"The 10% return we hypothesized is the average return of the American stock market since the Great Depression. If you are young enough, you could regularly invest a portion of your income into a simple Standard & Poor's 500 Index Fund at 10% compounded return and ultimately retire very comfortably.

"On the other hand, if you wait until you're 64 to invest for a retirement 12 months away, you have no time for your money to compound. You might as well play the lottery. At least there would be a remote chance you could win.

Mrs. Langerhorn looked piercingly at me. "Once again, we see that conventional wisdom is out of phase. How many times have you heard, 'It's okay to take risks with your money when you are young. You have time to make it again. But you can't take risks when you're old?' The fact is that if you have a lot of time for your money to compound, you don't need to take big risks. A young person can become very wealthy over 30 or 40 or 50 years by regularly putting a portion of his or her income into safe investments.

"But if you are older and there is not much time left, you have no choice but to take risks that would scare the Saints."

Well, that bit about being young and having time for money to compound certainly seemed inspirational. But I had come to the point where I wanted to know how much money I'd have to invest to become financially comfortable. I asked her, even though I was sure she would give me some equivocal answer that wouldn't be at all helpful. Instead, she taught me how to figure it out myself. *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.