The Most Important Thing in Investing

Back in 2006 I was celebrating 20 years of writing *Intelligence Report*. Debbie and I were in Vermont, and had just visited Vermont's Authentic Designs to purchase lighting fixtures. The shop uses 150 year-old machines to manufacture colonial and early American lighting fixtures. There, on one of the machines for all the craftsmen to see was taped a sign that read "Simple is Sophisticated."

After reading that taped up sign in Vermont all those years ago, I adopted "Simple is Sophisticated," as a personal mantra to keep me focused on the essential elements of my investment strategy. The most fundamental of these, and the one I have employed to the greatest benefit to myself, and hopefully to you if you have been a subscriber or client, is compound interest. Below you will read the story of how I have employed compound interest to the benefit of my grandchildren, and how you can do the same. I wrote back in May of 2006:

> ***Rich as Croesus***
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> *I want you to begin on your quest for sophistication through simplicity by focusing laser-like on compound interest. Here is an amazing story. I call it my grandchildren's "rich as Croesus" strategy. (Croesus was the last king of Lydia from 560–547 B.C.)*
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> *When each of my four grandchildren was born, I opened accounts for them at Vanguard's TaxManaged Growth & Income fund. Each year, I deposit $10,000 (and yes, I know you can now give away $11,000/year tax-free). The money is invested with little in the way of long-term tax implications. Let me show you how compound interest works its magic.*

> ***Gettin' Rich Slowly***
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> *If you invest for a compounded rate of return of 10%, it's easy to think that your long-term return would be twice the return gained by investing at 5%. That is not the case—not by a long shot. Let's take a long-term look here, for that is my intention with my grandchildren. Investing $10,000 at 5% for 50 years gives them $115,000—a staggering sum, to be sure. But at 10%, $10,000 grows to a mind-boggling $1,174,000 (that's million). Double the growth rate to 20% (admittedly unrealistic, but useful in this example), your $10,000 would become a stratospheric $91 million (over 77 times the return). And you thought you understood compound interest?*
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> ***You and Counterbalancing***
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> *As noted, a 20% annual return year after year is unrealistic. But you can achieve really terrific success, most conservatively, by counterbalancing your portfolio with fixed-income and common stocks. …*
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> *In 1989, the editors of Fortune published an article headed, "A Low Risk Path to Profits" profiling Loews Corp. money manager Joseph Rosenberg. Fortune noted that J.R. believed so fervently in the awesome power of compound interest that he carried a compound interest table in his pocket at all times. Sayeth J.R., "It is the most important thing in investing." As the article noted, it's foolish to undermine the power of compounding by taking big risks that kick you out of the game.*

As Rosenberg noted then, compound interest "is the most important thing in investing." If you want to succeed as an investor for your family, your grandchildren, or yourself, stay focused on the simple, yet sophisticated strategies that really make a difference.

My 1% Miracle: How to Avoid Outliving Your Money

Back in 1991 I addressed the most terrifying aspect of saving for retirement that any investor can face, the prospect of outliving your money. I cannot impress upon you enough the importance of saving more than you think you'll need.

Those of you who have been diligently saving and intelligently diversifying your portfolio through the last nine years of historically low interest rates are surely wondering if your savings will hold up after you retire. Ultra-low interest rates from the Fed have been a direct assault on retirees and savers. But now rates are rising, and you have the opportunity to participate in my 1% miracle.

I wrote the following back in 1991. The numbers for inflation and return don't coincide with today's reality, but the principles remain the same. Capturing higher rates of return as interest rates rise can have a big effect on your spendable income. I wrote then:

> *Do you believe in miracles?*
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> *Try this one for size. I call it DICK YOUNG'S 1% MIRACLE, and I think you'll be stunned.*
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> *I want to show you how just a 1% increase in your average annual investment income can increase the annual earnings from your investment portfolio by 40%. "Right Young," you say, "a 1% increase in income can translate into a 40% increase in earnings? Give me a break." But hold on, here's the miracle—along with instruction on how to apply my miracle to*

your own investment program today. See if you can beat this!

SPENDABLE INCOME ON $1 MILLION IS ONLY $20,000

Let's assume, for illustration, that you have a $1 million pool of retirement cash. Let's also assume 5% inflation, an annual 9% return on your capital, and a fair tax bite. Okay, 9% translates into $90,000 gross income on $1 million. With a 5% inflation rate, you must plow back $50,000 to capital to maintain future buying power. Most investors forget all about the inflation cancer that eats away at portfolio buying power. If you do not add back to your capital annually at the inflation rate, you are badly kidding yourself. Now, let's assume $20,000 in taxes—I'm being kind—on a $90,000 gross income. Don't worry about the preciseness of this tax figure; it doesn't matter, as you'll soon see.

After tucking away $50,000 to maintain purchasing power and paying $20,000 in taxes, your spendable income is only $20,000. That's it! And yes, that is the maximum I would personally plan to spend today out of $1 million in retirement capital. I know it's not a lot of money, but if you spend more, you are eating into your capital. Now you see why the financial problems of retirement are much more difficult than explained to you by most fuzzy-thinking financial planners. You cannot consume the host!

Increase Earnings 1%, Increase Spendable Income 40%

Now assume you increase your portfolio income by just 1%, to 10% from 9%. Gross portfolio income now becomes $100,000, up from $90,000. Tuck away the same $50,000 to maintain portfolio purchasing power, and pay taxes of $22,000 instead of $20,000, and what do you get? Instead of $20,000 spendable income, your spendable income becomes $28,000. How does $28,000 relate to $20,000? It's an increase of 40% in spendable income, just as I promised would be the case. To get this unbelievable 40%

increase in income, all that was needed was to improve your portfolio income by an annual 1%.

You, of course, are looking for flaws in my 1% miracle. But there are no flaws. And you are astounded at how little spendable income is available on $1 million at a 5% rate of inflation. You're not accepting what I'm telling you warmly and happily because the level of spendable income I'm suggesting is so unappealingly low.

<u>Don't Destroy Your Capital Base</u>

Don't fall for the tempting argument that $1 million is such a large sum, you can afford to accept a 5% per year decrease in earning power due to inflation—or even to dip into principal. To help you stay on the straight and narrow, ask yourself: "Do I expect to be alive 15 years from now?" Most people will answer yes—and with today's longer life spans, that's being realistic. If you retire at age 65, you stand a good chance of reaching 80. And if you retire early at age 55, as so many are doing, you certainly expect to be alive and kicking at 70. You definitely don't want to find yourself broke at either age 70 or 80.

How can you boost your return by 1% without magnifying risk? Craft a diversified portfolio and eliminate emotionalism from your investment process. That's easier said than done. If you need help, consider that Vanguard estimates that the potential gain from using an advisor to help manage your portfolio can add as much as 3% per year to your return. Working with an advisor on strategies such as rebalancing your portfolio, appropriate asset allocation, building a spending strategy, and most importantly guidance on what investments to make and which not to make can have a significant positive effect on your returns.

For a glimpse at how my family run investment counsel service helps clients implement those strategies, signup for the monthly client letter (free even for non-clients) from Richard C. Young & Co., Ltd.

Put the Odds on Your Side

Near the end of 1993, Debbie and I were hunkered down at The Dorset Inn in Vermont. Its wide pine board floors, restored tap room, gourmet dining room and antique-outfitted guest rooms make the small inn a special place to get away from the constant din of markets and politics. The events of that fall were oddly connected to this very moment in American history.

In November of that year President Bill Clinton told the world that North Korea must never be allowed to develop a nuclear weapon. And in December, Clinton signed NAFTA into law. Projections made in 1993 on how the Korean situation and NAFTA would turn out look poor in hindsight. Attempting to divine the future is a fool's game, and as I wrote back then, in investing you must "invest in what you know to be true today, not in what you think will be true tomorrow."

I wanted you to focus then on the value of putting the odds on your side, and I still do. I wrote:

> *OK, given that there is a lot of similarity among long-term results and that different styles of investing, as well as managers, come in and out of style, what's the best strategy for successful mutual fund investing? How can you be a consistent winner with confidence?*
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> *At the top, invest in what you know to be true today, not in what you think will be true tomorrow. Insist on putting the*

odds on your side. Take full advantage of the tools of the mathematician. For example, here's a little mathematical shortcut you can use to determine compound interest. How long does it take for money to double at a predetermined rate of interest? Use the Rule of 72. Simply divide the rate in question into 72. If your interest rate is 9%, money will double in eight years (72 ÷ 9 = 8). That's all there is to it. Compound interest should be your most trusted investor ally (aside from Dick Young, of course), and the Rule of 72 can help you understand the value of compound interest.

Putting the odds on your side—such as understanding the power of compound interest—will make you a winner. That is most certainly your first rule for successful long-term investing.

Don't let unsure expectations of what will happen in the future cloud your investing judgement. You must instead seek to minimize risk, investing in dependable streams of income, and harden your portfolio against uncertainty.

When Investing, It's Better to be a Leper than a Lemming

During my five decades of investing, I have more often than not been arguing against the going wisdom of the markets. To call me a contrarian would be accurate. Leper investor also fits.

In December of 2001, I explained what I called "Leper Investing," to my readers.

Leper Investing

> *In order to invest successfully over your lifetime, you need to act counterintuitively; that is, against the prevailing Wall Street wisdom. You want to buy contrary-opinion names—those stocks loathed, despised, and shunned by the institutional magnets. Your caches of lepers will generate above-average returns for you when you exercise patience. You must be ahead of the curve to invest this way. You must have vision and patience and be able to look over the horizon. Most often, you will want dividend-payers.*

Later I went on:

> *I've suggested that conservative investors buy only dividend-paying stocks. I can't emphasize this rule strongly enough for you. My Retirement Compounders program is built 100% on dividend-paying equities. Ben Graham, the father of value investing, said, "One of the most persuasive tests of high quality is an uninterrupted record of dividend payments." Burton Malkiel, Vanguard trustee, Princeton economics professor, and author of A Random Walk Down Wall Street, one of the best books ever written on investing, wrote in his book, "Historically, high-dividend yields have meant better returns…looking for above-average yield is itself a contrarian strategy. Investing in high-dividend stocks therefore is likely to lead you to attractive issues."*

I continue to encourage investors to seek out unloved, forlorn and out-of-favor stocks with a focus on those paying dividends, and with a history of increasing those dividends each year.

Does Your Portfolio Pass My Three Step Test for Balance?

Back in 1993 I explained my three-step test for balancing your investment portfolio between bonds and stocks. At the time I was recommending Treasuries, but you can use this advice no matter what kind of bonds you're buying. Use your age and my three-step test as a starting point for how you plan to allocate your portfolio. I wrote:

> *I want you to keep your investment portfolio well balanced. But just how much of your portfolio should be invested in equities and how much should be in Treasuries? Here's a basic strategy that is based on your age. The percentage of your portfolio that is in Treasuries should not exceed your age. For example, if you are 60, you will want a maximum 60% Treasuries component. That's your starting point. Now take these tests to see if you need to reduce that percentage. If any of these statements fits you, knock 10 percentage points off your age number. But you will only knock off a maximum of 20 percentage points in total.*
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> *Test #1: You do not require current income from your portfolio to live on. If that sounds like you, knock off 10 points. Test #2: You consider yourself to be a sophisticated, patient, seasoned investor. Answer yes to all three descriptions without a wince or snicker, and knock off 10 points from your age percentage number. Test #3: You are financially secure, if not wealthy. If you have what you believe is a solid store of financial wealth, knock off 10 points from your age percentage figure. If you qualify with two or three tests, you can knock off the maximum allowed, 20 percentage points, but no more.*

A fixed income component to balance out your equity portfolio is a vital necessity for any serious investor focused on income generation and capital preservation.