MuhlenkampMethods For the Intelligent Investor

Answers to questions you may not even know you have.

Working, Saving, and Investing

This essay by Jeff Muhlenkamp was originally published in Muhlenkamp Memorandum Issue 110, April 2014. When Jeff's kids started asking questions about Ron's investing process, he found it difficult to answer them well because every question they asked required explaining at least three additional concepts. These concepts are both fundamental and critical to the exercise, so he organized his thoughts and tried to keep it very simple and clear (not comprehensive, because that is appropriately the subject of a book).

Why do we work?

To start, we work to eat. In the final analysis, unless someone is working and sharing their food with you (taking care of you like when you were a baby), you have to work to eat. If you are being taken care of by the government—welfare—someone has to work to pay the taxes so you can eat; they are supporting you. Perhaps earning enough to eat takes a lot of work, perhaps not. Once you earn enough by working to eat (and buy clothes, and have a place to stay), then you can buy luxuries—whatever that means to you (a toy, a bigger TV, a vacation, a larger house; the possibilities are endless). Maybe once you earn enough to support yourself, you decide to take care of someone else—that could be a child of yours, an old person who can't work anymore (like your Daddy in his dotage, hint, hint). Perhaps you want to give to charities that support people who can't support themselves. While you are working you will be paying taxes to the government; you will be taking care of others, whether you want to or not.

Why do we save?

Three reasons I can think of... The first is because you think there might be a time in the future when you are unable to work; maybe you will be laid off from your job, maybe you will get hurt and can't work for a while. You save now, so when you can't work you can still eat; you are saving to help



yourself through tough times. A hundred years ago when most people farmed, they saved (stored) food in the summer and fall when the crops were ripening to get them through the winter when food wouldn't be available. They saved during good times to avoid starvation during bad times; (the Bible mentions this a bit as well). This is the most important reason to save.

The second reason to save is because you want to buy something, but you don't have enough money. You could try to borrow the money and buy it now, but that would drive up the total cost of the purchase because you would have to pay INTEREST on the money you borrow. (Interest is the cost of borrowing money.) Or you could save your money, and buy it once you have enough.

The third reason to save is because you think it might be nice to quit working in your old age and still eat without depending on the charity of others (your kids or the government, which amounts to your kids anyway). This is called retirement and while some people think it is a god-given right, it really isn't. You have to save enough that you can still eat without working. Social Security (government support) may help a little bit, but it isn't enough to support you in retirement all by itself; never was, I don't expect it ever will be.

Why do we invest?

In a general sense, we invest to make our lives easier. Cyrus McCormick could've simply kept harvesting wheat by hand like he had done most of his life and like his neighbors were still doing. Instead, he invested his time along with his own money and some neighbors' to develop a mechanical reaper that saved him, his neighbors, and pretty much farmers everywhere, a lot of time harvesting wheat. As a side benefit, he made wheat cheaper for people who wanted to buy it. He spent time and money in the present to save more time and money in the future. He was successful—and the tool he developed has saved mankind a lot of time and money. That's what companies continue to do today: invest time and money, developing products that make our lives easier, cheaper, or better in some way. You can choose to participate in that process by investing in companies. By putting your money back to work (by lending it or investing in a company), you create the possibility of growing your wealth without working harder or longer. Investing can be a labor-saving device for the investor as well as the purchaser of the product.

The "power" of investing comes from a concept called "compounding." Let's say you have \$100 and you lend it to someone at 10% interest for a year. At the end of the year, you'll receive \$10 interest and the \$100 in principal (\$110 total). If you re-invest both the principal and the interest at 10% for another year, what happens? At the end of the second year, you receive \$11 interest and \$110 in principal



(\$121 total). Do it again and what happens? At the end of the third year, you receive \$12.10 in interest and \$121 in principal (\$133.10 total). Keep this up and you'll have \$161.05 after the fifth year, \$259.37 after the end of the tenth year, and \$672.75 at the end of the twentieth year. Your money is growing EXPONENTIALLY, not linearly.

It is important to remember three things about compounding: first, the length of time you let your money compound is most beneficial; the second most important thing is the rate at which it compounds; the third most important thing is that siphoning off money to spend it or pay taxes reduces the benefits. So, compound for long periods of time, preferably at high rates and protect it from taxes.

There are three things you can do with your money once you have earned more than you need and have decided to save or invest some of it:

- 1. Put the cash in a safe place and leave it there;
- 2. Lend it to someone and receive interest; or
- 3. Own all or part of a company that makes money by providing a good or service that people value enough to pay for.

Cash (or savings)

This means putting your money in a piggy bank on your dresser. Unless someone steals it, you will not lose your money. If there is inflation (the value of your money decreases, but you can't really tell...what you do notice is that the price of everything seems to go up), you WILL lose purchasing power. Here's an example: you save \$100 and put it in your piggy bank. On the day you put it in your piggy bank you could have bought 101 songs on iTunes at \$.99 each. A year later, songs on iTunes cost \$1.01, so you can only buy 98 songs. You still have \$100 dollars, but it doesn't buy quite as much as it did. The value of each dollar went down; in this case, by about 2 percent. So, you have two ways to lose your money if you keep it in cash. Someone can steal it, or its value can decrease because of inflation. The first risk is pretty low if you keep it in a safe manner. The second risk is a certainty; the rate of inflation changes—it almost NEVER goes away completely. Cash isn't really investing because it doesn't take advantage of compounding interest.



Lending

When I talked about borrowing money, I said the cost of borrowing was interest. In that case, we talked about you paying interest in order to borrow. Now, we are talking about being on the other side, by being the lender. You lend your money to someone for a period of time and COLLECT the interest. The interest you collect may be a fixed amount per dollar (usually expressed as a percentage of the amount you lent), or a variable amount which may change based on some index or, perhaps, the measured rate of inflation.

Putting your money in the bank isn't really saving, even if the bank calls it a "savings account." This is because you are lending your money to the bank and it is, in turn, lending it to other people. (In the process, the bank will charge more interest than it pays you—that's one of the ways banks make money.) The good news is you are earning interest. If the rate of interest is greater than the rate of inflation, you can grow the purchasing power of your money over time. Now your money is working alongside you, growing your wealth.

One of the ways to lend money is to buy a BOND. A bond is simply a contract between you (the lender) and a borrower that stipulates for how long you are lending money, what rate of interest you receive, how often the interest is paid, etc. The interesting thing about a bond is that you (the lender) can sell it to someone else—and they become the lender! So you get cash and they receive the interest payments for the remaining life of the bond. The key thing to know about bonds is that their value (the price at which you can sell them before they come to an end or "mature") goes up, if the prevailing interest rates go down, and goes down, if the prevailing interest rates go up! This means two things. You can make more money investing in bonds than just collecting the interest payments. (If interest rates have fallen since you bought the bond, it will be worth more than what you paid for it if you sell it.) The flip side is, if interest rates have gone up since you bought the bond, you can lose money if you sell it. The most common reason for interest rates to go up is that inflation has gone up. So if you sell the bond, you'll lose money. If you hold it until maturity, you won't lose any money—but the money you receive will be worth less. As a result you will have lost purchasing power, which is what we really care about. So, you can make or lose money in bonds if interest rates change. You can also lose money if the lender can't pay you back. There are more ways to lose money or purchasing power with bonds than with cash, but more opportunity to grow your purchasing power as well.



Owning a company (most often done by buying stocks)

The biggest reason to own stocks is that historically, returns on stocks have been better than returns on bonds over longer periods of time (more than about three years). This isn't true for every period, but it's true for most periods. The drawback is prices for stocks change every day—sometimes, by a lot. Many times the reasons stock prices change have nothing to do with the company you own, or may not appear to have any reason at all. This price volatility has been called "risk" by a lot of people on Wall Street. I prefer to think of "risk" as the possibility of losing purchasing power. (Holding cash when inflation is high is quite risky, as you are sure to lose purchasing power—but, it is not volatile, since the number of dollars you have doesn't change.)

Anyway...back to owning companies. How do you decide which company (or companies) you want to own? I approach it like any other purchase: I want to get a lot, for a little (money). A lot of "what" you ask? A lot of profits for each dollar I spend. A company combines labor, raw materials, and tools (capital) to produce a good or a service; for example, a car, a hamburger, a haircut. Profit is the difference between what the customer pays and what it costs the company to buy all the inputs. If customers value the product of the company highly and are willing to pay more for their product than it cost the company to produce it, the company will prosper. Not all companies are equally profitable. You want to look for companies that are more profitable than most. The best measure of that is return on equity (ROE). You are looking for a company with a high ROE, and you want to buy it cheaply. The price to earnings ratio (P/E) is a simple way to look at how cheap a company is. The average company has an ROE of 13%-15%, and historically, the average P/E is about 15. If you can get an above-average ROE at a below-average P/E, you ought to do OK. That's a good start.

You also want to form an opinion about two more things:

- Is the ROE sustainable over a long period of time (is the company going to keep making a lot of money)?
- Does the company reinvest its profits wisely?

Remember our discussion of compounding interest? If a company is profitable and invests its profits wisely, the value of the company will increase at a geometric, not a linear, rate. That's what you want! Remember the part about compounding over long periods of time at high rates without paying taxes? That is what owning such a company allows you to do. If the company pays out its profits as



dividends, you'll pay taxes, reducing the compounding effect. If you buy and sell stocks frequently, you'll pay taxes on any gains, also reducing the compounding effect. If you find the right company, it will do the work for you. To form an opinion about profitability, it is helpful to look at how ROE has done over time and what the company's management says it wants to do with its money. This is a judgment call because knowing the past does not imply you know the future. Companies that are very profitable, yet pay out most of its profits to shareholders in dividends—or use profits to buy back shares of its stock—are good uses of profits, but you won't get the same compounding effect as a profitable company that REINVESTS its profits well.

Last thing about stocks... Periodically, they go on sale—sort of like an after-Christmas sale, except nobody announces the sale ahead of time so you don't know when it is going to be. When the stock market goes on sale, (often triggered by a recession in the economy), the price of some stocks declines more than others. As with other purchases, one way to get a lot for a little is to wait until there is a sale! So if there is a company you like, but its stock is too expensive right now, keep an eye on it and be patient; chances are it'll go on sale. While you are waiting, check out the companies whose stocks are currently "on sale" and see if you like any of them.

Now, some very specific advice for you:

1. Take maximum advantage of tax-avoidance investing. If the company you are working for offers a 401(k) or similar retirement plan, take maximum advantage of that—particularly if the company matches a portion of your contributions. A 401(k) allows you to invest your money before you pay income taxes on it; thus, it allows you to invest more than if you had to pay taxes first. Fully fund it every year.

If you are eligible, open a Roth IRA. You will have to contribute after-tax dollars, but you won't pay taxes when you withdraw the money in retirement. If you aren't eligible for a Roth, then fund Regular IRAs (Individual Retirement Accounts). You contribute after-tax dollars, but you defer paying taxes on capital gains, interest, and dividends until you withdraw the money in retirement. Fully fund your IRAs. Put your contributions to any of these accounts in a mutual fund you like or an ETF (Exchange Traded Fund) that tracks the S&P 500 Index; it's likely you'll do fine.



- 2. Create a "rainy day" savings account and put about six months' worth of expenses in it. This account is for unexpected expenses. It can serve as a buffer that prevents you from having to sell investments, if it happens to be a really bad time to sell investments (because they are all on sale). Remember: you want to buy stocks when they are on sale and avoid selling what you already own when they go on sale.
- 3. If you want to invest more than you can put in your tax-exempt or deferred accounts, I suggest putting a certain amount of money in a savings account every month. Call it your "investment account" and don't spend it on a vacation, a new furnace, or new carpet—protect it. When the headlines in the newspaper announce "U.S. in recession," split the contents of your "investment account" into 6-10 pieces and invest one piece every month for the next 6-10 months. Put the funds in your favorite mutual fund or an ETF that tracks the S&P 500 and leave it alone. Start rebuilding your "investment account," wait for the next recession, and do it again. The goal is always to buy when the market is on sale and, as importantly, NOT to sell when the market is on sale. You don't have to predict when a recession (hence, a sale) is coming, you simply have to save your money until the sale (recession) happens, then, put it to work. This simple rule will help you do that.
- 4. Dollar cost averaging. Many investment professionals will tell you to simply put a portion of your paycheck into an investment (mutual fund, ETF, whatever) and leave it alone. This is a pretty good plan. You buy more shares when they are cheap and fewer when they are expensive, so it helps you buy at lower prices on average. If you don't have the discipline to follow the plan in #3, dollar cost averaging is a decent alternative.
- 5. Dollar cost averaging is a simple rule that helps you buy low(er). There is also a simple rule that helps you sell high(er); it doesn't have a name and I've yet to hear any adviser discuss it. When you sell, instead of selling a constant dollar amount every period of time (as you are encouraged to do, for instance, with the required minimum distribution for IRAs), sell a constant number of shares per time period. This will generate more proceeds in dollar terms when the asset is at a high price and less when it is at a low price, so you'll be selling high(er) than otherwise. If you are selling assets regularly to cover living expenses (because you are retired), or taking required minimum distributions from an IRA, you will need to set it up so that during "normal" market conditions you are redeeming more in dollar terms than you need (say 30% more), so that when the market falls, you aren't caught short. Take the excess you are redeeming during the good times



Working, Saving, and Investing – Page 8

and put it in a savings account, forming the buffer for the bad times so you don't have to sell when the market is down.

Any tax or legal information provided is merely a summary of our understanding and interpretation of some of the current income tax regulations and is not exhaustive. Investors must consult their tax adviser or legal counsel for advice and information concerning their particular situation.

Dollar Cost Averaging involves continuous investment in securities regardless of fluctuating price levels of such securities the investor should consider his/her financial ability to continue purchases through periods of low price levels. Such a plan does not assure a profit and does not protect against loss in declining markets.

