

# Thinking Patterns

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2006:10

## Introduction

Investors oriented towards the long-term possess a rather unique view of the world. Their pattern of thought will be intuitively aimed at a long run perspective of their own economic activities. Many such investors will have little or no formal education in the fields of finances, economics, or investment. They are merely everyday business men and women with time horizons of many years and even decades. The long-term perspective serves them well, however. It not only sets them apart from the rest of the investing masses, it also provides them with a built-in advantage.

## Net Worth

The central core and precept of many individuals with a long-term belief revolves around net worth concepts. To be precise, the increase and expansion of net worth. Many people will try not to maximize taxable income at the personal level, nor even the earnings of businesses. There is little or no interest in realizing capital gains of any assets. Instead, there is a general preference to keep the gains in an unrealized state, so as to maintain and enhance the value of the asset without cashing that asset into a realized gain, for tax purposes.<sup>1</sup> At times, this produces a “cash poor” position. But it is all for the long-term enhancement of the net worth at the personal level.

Many investment advisors suggest, as an overall goal, to double a capital investment every seven years or so. That works out to be a 10% rate of return. While this is very important advice, it is not enough to merely focus on the rate of return to investments. The individual investor’s net worth position should be the activity that is increased on an on-going and regular basis. The goal should be to enhance one’s own economic position, or overall net worth. If only high rates of return are sought, the net worth position will probably increase by less than that. Capital gains from existing assets plus new investment money from savings generates the increase to a net worth position. Thus, overall worth is sought to be maximized, and not just the gains from capital investments. Investing chiefly involves the thinking patterns of individuals who are committed to maintaining and enhancing their net worth positions.

## The Thinking of Millionaires

A while back, a wonderful article appeared in the business pages of the local newspapers. Two scholars conducted a survey of millionaires around the nation. They wanted to

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<sup>1</sup> This is consistent with John Templeton’s belief that long-term investors should have only one objective – and that is to maximize the total return after taxes. See, *Stocks for the Long Run*, Jeremy Siegel, 1998, at 115.

know how millionaires thought, how they acted, and how they got to be millionaires in the first place. The results of the survey were so interesting that a book even flowed forth.<sup>2</sup> The first book proved to be so popular, and no doubt profitable, that a second book was penned on the same subject.<sup>3</sup>

These two researchers discovered that most millionaires were not flashy kinds of people. Mostly, they were rather modest in appearance. They drove ordinary looking cars and lived in nice homes that were not outrageous spectacles. They did not spend that much. Some of them were quite skimpy with their cash outlays. Many millionaires did not even tell their children that they were rich. They didn't want the kids to have over-inflated egos. The survey showed almost all of them to be hard working people. Very few of them ever retired, even after they could financially afford to do so. The greatest surprise of the whole survey was that almost all of them (95 % +), never made an excessive amount in any one year. A \$100,000 + salary was the exception, not the rule. The deca-millionaires typically had a much higher salary range, but they also led comparative modest lifestyles.

On finance strategy, many of the survey participants felt that it is not what a person actually makes from a paycheck that is important. It's what the person saves and invests that is critical. The survey responses showed an almost instinctual reliance upon long-term investing. Almost none of the millionaires engaged in market timing or technical analysis. Some of them didn't even know what sophisticated finance activity entailed. They rarely traded, either. They bought solid, core stocks, and then left them alone. Further, they invested regularly in both small and large increments. The survey participants tried to buy companies that had been around for a long time and companies with products that they liked to use. They owned private companies, as well. In fact, many of the millionaires' wealth stemmed from the productivity of their very own businesses. Investing became so automatic and normal an activity that it became a way of doing things, even a way of life.

In the survey on deca-millionaires, the top five most frequently noted factors responsible for their success and wealth were the following: hard work, integrity, discipline, social skills, and a supportive spouse. Having a great rate of return on their stock portfolio was not a critically important factor. Two of their most favorite past times included socializing with close friends and watching the sports games of their children and grandchildren. Vacationing in the Alps didn't make the cut. Neither did a world-wide cruise. Being with close friends and watching the sporting events of their children was very high on the favorite pastime list.<sup>4</sup>

Another study has also indicated much the same. Some economists surveyed various individuals who accumulated wealth rapidly. It turned out that families with fairly low earnings patterns were the ones that accumulated massive amounts of savings and

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<sup>2</sup> *The Millionaire Next Door*, Thomas J. Stanley & Wm D. Danko, 1996. Through 1996, there were 3.5 millionaires out of 100 million households in the U.S. There were 175,000 Deca-millionaires, or 0.175% of all households. Millionaire households accounted for nearly 50% all private wealth in the country.

<sup>3</sup> *The Millionaire Mind*, Thomas Stanley, Pocket Books, 2000.

<sup>4</sup> *The Millionaire Mind*, at 11, 87-130.

retirement accounts. How could this be? The study did econometric sorts for probability type of factors that could statistically explain the pattern. Personal health, inheritance, investment choices, and random chance were all ranked by likelihood of explanation. The factor having the highest probability was the savings choice. It wasn't the choice of particular investments that accounted for wealth accumulation. And, it wasn't the amount of inheritance, either. What mattered most was the simple choice of certain families to consistently and regularly save and invest versus the choice of other families to consume and spend.<sup>5</sup>

So, millionaires are not anything like the stereotype. They turn out to be ordinary individuals. The only difference between most of the millionaires and everyone else is their thinking pattern. They are into the long-term. Into hard work and savings. Into a way of life.

### **The Zen of Investing**

Once a person has all the money he or she really could ever use, many individuals will then take care of the loved ones, and will be charitable with the rest. It is the Zen of Investing.

There also happens to be a strong economic reason to be kind and charitable. Taxes. Or the reduction of taxes, to be more precise. Charitable donations are treated as a personal deduction for tax purposes. Personal deductions subtract from the adjusted gross income to arrive at the taxable income. If a person is at a 35 % tax rate, every dollar of charitable donation could generate 35 cents in tax reduction. Next time the reader is considering a sale of a long-term equity having significant capital gains, please consider whether the cash is really needed. Maybe, charitable, tax reduction route can be used, instead. Look for the favorite charity.

Many concepts of Finance resonant at the personal level. While some Finance theories involve quite sophisticated mathematical tools, many investors have used simple financial beliefs to make basic lifestyle choices. The long-term view of finance is a philosophy of life as much as it is a view of investing. Individuals sorting through their own personal motivations and desires over risk and investment preferences will have emotional events laden with conflicting and overlapping goals, desires, and rationales. This is life. Whatever the chosen field of work, whether it is investing or some other activity, do the best that can be done. So many people perform at a sub-optimal level. We would not invest in a company's performance that is below professional business standards. Likewise, we should not ourselves perform below our own abilities. Human potential is just the potential until the human performs. Change jobs if the job is boring. Better yet, create the job with which one can perform up to his or her highest abilities.

So many of the financial gurus and industry barons ignore or simply forget one basic ingredient of the human experience: to enjoy one's own life. They get so wrapped up in performance statistics of their company that they forget about their families and

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<sup>5</sup> "You Don't Have to be Rich to Save a Big Nest Egg", *St. Louis Post Dispatch*, Sept. 1, 2000, p.c12.

themselves. Don't hoard all the money invested. Take a trip with some of it. Take the family on a nice vacation, away from phones. Enjoy everything life has to offer. Enjoy Life. Then, sometime in life, even if it is just one time, give back to the community. Improve the human experience. Give something back at some point in life. It is the human thing "to do."

### **Invest Throughout Life**

Investing can be a continual endeavor and goal in one's life. Investing becomes part of everyday life for many people.<sup>6</sup>

In the early years of a person's life, an individual can best prepare for his or her own future through education. Both academic and work experiences are important. A person needs a basic education to be employable and functional in today's society. The individual can then develop a greater sophistication and appreciation for the nuances of life through further education at the college and graduate levels, although such coursework is certainly not necessary.

Everyday life experiences can be a great source of education. Cut the neighbor's grass for a summer. Bag some groceries at the corner store. Run a paper route for a year. Dig some ditches for a while. Enjoy team sports. Take up yoga. Take long walks in the park with the elders. Dig some more ditches. Get to know the people digging next to you. Fall in love. Fall out of love. All these things add to up to life's experiences.

In the early years, don't be too concerned about money. Making money can come later. The best preparation for a future in sophisticated financial analysis is to learn. Financial investment decisions will flow rather naturally if one is prepared at earlier stages. This learning process goes on throughout one's life. A person is never too old to learn.

Involvement with financial investment takes one irrefutable and critically important thing: money. There is no sense in worrying over investment choices if a person has no capital. And to obtain the necessary capital, most people have to get a job. Some very lucky individuals may inherit wealth, but most people have to acquire and develop capital the old fashioned way – they have to earn it.

So a basic step towards a lifetime of serious investing is to get a job. It doesn't have to be a high paying one, either. It is not what you gross in income that counts, it is what you save (and invest), that really matters. As noted in the above paragraphs, many millionaires have never had a tremendously large salary. They just have small amounts of debt and expenses, and they save as if there are a thousand rainy tomorrows.

And what kind of job should it be? Well, any kind will do for the most part. The focus should be on finding a job that is enjoyable. Then it is not work, it's fun. Employers will look at numerous factors in choosing someone as an employee. These include a strong

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<sup>6</sup> Burton Malkiel has very similar thoughts in a nice chapter of his book *A Random Walk Down Wall Street*, 6<sup>th</sup> Ed., 1996, devoted to a life cycle of investing. See, ch.14.

work ethic, basic skills, teamwork, computer literacy, dependability, communication skills, responsibility, initiative and drive, and openness. There is a large salary gap between the low skilled jobs and those taking a higher skill level. Education pays.<sup>7</sup>

Once a person has a regular source of income, investing can then become a regular habit. Save a little every month. Put some income into a retirement account on a regular basis. At first, it will be a struggle just to pay bills. But after a while, cash and retirement savings will accumulate. A residential purchase will also add to a person's net worth, at least over a long time.

After a person settles into regular employment, the individual can then focus in on, or specialize in, a particular type of employment or economic area. This concentration may very well allow the individual to increase his or her own gross income. With specialization, or at least a greater intensity or knowledge of work, comes a greater demand for the employment, service, or product, and thus, the personal income may be higher.

As a person's cash reserves escalate, the individual's style of investment may change, as well. If cash is not needed for immediate needs, the individual may be able to increase the general short-term risk of an investment portfolio, so as to maximize the long-term gains of the cash reserves. Thus, a person may move towards a more aggressive position in stocks. Dividends and mutual fund capital gains may now be able to be reinvested regularly, since there hopefully will no longer be an immediate need for cash. This would further accelerate the individual's net worth.

As net worth goes up, a person's abilities at obtaining credit also increases. A strong financial position at the individual level will open up both personal and commercial lines of credit from banks. In many instances, banks will even extend favorable terms, since the individual is seen as a good risk – if the person defaults on a loan, the bank can get the cash from the individual's investment reserves. Cash is the modern day equivalent of gold. A strong financial statement is the modern day version of a key to the bank vaults containing the gold.

With a strong financial position, an individual can now really focus in on maximizing investments. In fact, many people will now be at a stage in their life where they can take on the challenge of owning and running their own business, or even businesses. They have the education, the experience, the motivation, the capital, and most importantly, the great credit rating to pull off direct development and control of their own business activities. Such individuals go from trying to maximize their investments at the individual level, and move towards maximization of their net worth through numerous business activities. No longer are these people thinking in terms of holding onto a job. They are trying to boost gains to their capital structure through control and delivery of a product or service that people are willing to pay for.

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<sup>7</sup> A good discussion of job and education requirements, oriented to teenagers, can be found in *Investing For Life*, NAIC, 1997, at 11-20.

Such business ownership is not necessary for successful investing. But, it is a rather typical activity to engage in by individuals that have become used to a lifetime of investing. The greatest gains to capital often can be produced from very tight knit, well run, private businesses that are extremely focused at product or service delivery, and with expense minimization. So, it is natural for a long-term investor to think of controlling these kinds of businesses. One has to be extremely careful, though – so many small, private businesses fail miserably. But, if an investor is already used to looking at all of the economic fundamentals of any well run public corporation that they are thinking of investing in, then they may also be successful at developing a controlling position in local, private businesses that meets all of the same long term growth characteristics.

This is the time in a person's life to make some hay. Regular, long term investing can now produce some truly staggering gains.

After building up large cash and retirement stock and bond reserves, as well as having significant worth in local businesses and real estate holdings, an individual may want to kick back his or her feet and enjoy the good life. No amount of money in the world can buy the love and affection of a spouse or child. No amount of gains in the stock market will substitute for the view of the ocean on a calm and sunny day. So, relax, and enjoy.

Many people will now retire. Others will move to part time status. Still others will continue working because they truly enjoy it. The important point is that through a life of continuous and regular investing, a person can develop the financial independence to be able to anything. Or nothing.

Does that mean that folks will now stop investing? No, hardly. By now, the pattern has become so ingrained in one's mind that saving and investment has long become a routine activity. Like doing the laundry. Going to the store. Putting some money in a savings account. Looking at a company's earnings, and then investing in it. Investment styles may become more conservative, but investment still occurs. Many times, investors at this stage will back off from growth stocks, and will move towards a mix of income stocks and bonds, and less volatile equities. They now have near term cash needs, and may not be able or willing to absorb the hit of a high-risk equity rapidly plunging in price. But many people will still continue their investment goals.

A person, at this stage in his or her investing career, will probably be drawing from accumulated assets for current year needs, instead of relying upon a job or a business to pay for current year revenues. That is what retirement is all about. Typically, net worth will at first peak, and then gradually decline during the later years of a person's life.

In some instances, however, net worth keeps shooting up, even after an individual starts to draw off of the asset reserves. This occurs where a person just does not need much to live on, and where assets are significant to begin with prior to retirement. In such a case, a person's equities could keep increasing. The investor thus may end up with far more money than he or she ever dreamed possible. In the early parts of one's life, an investor may be ecstatic over a \$10,000 gain to the portfolio. By retirement, gains of hundreds of

thousands of dollars are possible, and just as easy to produce as the smaller gains earlier on in life. The rule of compounded returns now comes into play, resulting in amazing, and even unbelievable, increases in a person's worth.

As people advance in years, they begin to think about giving their assets to others, once they are gone. The legal device called probate is that precise mechanism by which a person wills and bequeaths all their earthly remains to others. Individuals can celebrate their own life, and give their hopes and aspirations to the lives of others, by bequeathing their assets. Inheritances to friends and family members. Bequests to charities and civic groups. A fitting tribute to be carried into the next lives to come onto this earth. A philosophy of investment that benefits both the person's own life, and hopefully, the lives of others to come along in future years. Truly, a celebration of life itself.

### **Anyone Can Do It**

A person does not need a graduate degree in Economics or Finance to make sound financial decisions. All a person needs is to be able to analyze some rather basic financial information on a business or other investment, and then apply rules or guidelines on when to buy, hold and sell the investment. The financial information that is needed can be obtained at the nearest library, or through the Internet. Most of the information is available for no cost, or for a modest fee. Nothing fancy. High school students, laborers, senior citizens can do it. The quicker a person realizes that they can engage in sophisticated investing without high-powered technical analysis, the quicker a person can develop financial and economic freedom and independence. *Anyone Can Do It.*<sup>8</sup>

Financial professionals will often comment on the present-day complexity of the markets, mention the vast amounts of education they have, and then generally recommend that a professional take charge of an individual investor's portfolio. Some professionals will even note that people don't normally attempt brain surgery by themselves, or try to go fly a commercial airplane. No, people will let professionals do these things. So, goes their argument, why would people really want to try all of this finance stuff themselves, when trained and highly competent financial professionals are out there to do the job for them?<sup>9</sup>

That argument might actually make some sense, if only there was any proof that the professionals could make a difference when it comes to finances. A trained doctor is necessary for surgery, and a licensed airline pilot is needed to adequately fly an airplane. Unfortunately, there is little or no proof that a financial professional can do any better than an individual investor who is willing to devote time and energy to the task. Most

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<sup>8</sup> This belief in one's own abilities regarding investment is not just my idea. A number of the individuals in the investment community feel that "anyone" can do it. The NAIC has been teaching this philosophy for over 50 years. Further, the central premise of Peter Lynch's writings is that amateurs can ferret out superior investments through their everyday life experiences, and without all the finance theory that can actually hinder the professionals, at times. *One Up on Wall Street*, Peter Lynch, at 13-15.

<sup>9</sup> This argument comes from Peter Tanous in *Investment Gurus*, 1997. Aside from the particular argument, the book has some great interviews with top-notch finance professionals.

financial professionals will under-perform the broad market indexes. That's a simple fact.

The NAIC, AAIL, Value-Line, and many other sources give people many of the tools necessary to make intelligent investment choices. It does take lots of work effort and perseverance, but like everything else in life, if the individual is willing to make a commitment to it, anyone can do it.

### **Gather Information**

Once the fundamentals of long term investing are better understood, actual asset selection can begin.

To locate likely investments for consideration of hard earned time and money, one should read. Then, read some more. Wonderful places to search include the business section of the local library. The Wall Street Journal. Almost anything written by The National Association of Investment Clubs, now called BetterInvesting. Value-Line Stock Reports (a great source for both statistical data, and qualitative information). Standard and Poors reports. Moody's. The Guide to Business Periodicals. Financial newsletters, and annual summaries, from S&P, Kiplinger, United & Babson, Value Line, Hoovers, and many others. Most are available at public libraries. Internet business sites (thousands of them). Warren Buffet's books. Peter Lynch's books (also available at the library). And that is a short summary of only the free or low cost material. Just never stop reading.

Further, talk to the local stock-broker. That is what they are there for. And talk to other people, as well. Some call it the "scuttlebutt".<sup>10</sup> It is a good source of information. Good, quantitative information is essential in the development of long-term trends.

### **Invest in the Long-Term**

While just about anyone can develop the knowledge to make informed and sound investment decisions, it does take time and dedication. This paper does not advocate a Get-Rich-Quick scheme. If the goal is to make a million today, or maybe by tomorrow, then buy a lottery ticket and take the 1 in 6.2 million chance of hitting it rich. No quick fixes, here.

A long-term investment philosophy is highly desired.<sup>11</sup> There are few quick ways to make a fortune, unless of course, it is inherited. And then, the gains of someone else's long-term investment philosophy are received. No quick fixes, just time, and dedication.

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<sup>10</sup> Fisher dreamed up the term "scuttlebutt". *Common Stocks, at 16-18*. Buffett also has used the same term in his annual reports of Berkshire Hathaway. Both individuals believe in gathering information through lots of individual conversations with a wide array of people. And, Lynch advocates the same fact-finding process in *One Up on Wall Street*, at 182.

<sup>11</sup> Numerous investors advocate the long-term. NAIC tries to double the investment every 5 years. *Official Guide*. Buffett has a grouping of privates and publics which he considers to be "permanent". *The Warren Buffett Way*, at 99-158. And, Peter Lynch feels that most of his investments first begin to make money in the 3<sup>rd</sup> or 4<sup>th</sup> year. *One Up on Wall Street*, at 272.

Either the investor's time and dedication to make investment decisions, or the person's time and dedication who made the bequest. In either event, investment is not a one-day consideration. True Investment can only occur in the long term. Investment is the long term. Everything else is just mere speculation. Sure, there may be short-term buys out there that will make a great deal of sense at times. But, investors may not succeed unless the investment decision is based on long-term considerations.

But what is the long term? At a minimum, an investor should have a five-year perspective. Most sound financial decisions work well with the longer periods. Anything shorter, and people do not see the full benefits of their investment choices. Their informed decision may very well under-perform for the first several years, or even worse (as in plunging dramatically in price). But, if the business is on a sound financial footing, any temporary setbacks of the company will be just that - only temporary. Over the long haul of several years, any short-term problem will work itself out, and the long-term trend of the business will begin to develop. So, the longer a person holds the investment, the less risk of a loss due to minor problems or external events.

The financial statisticians refer to this as pricing variance, and this is something that will be discussed in much greater detail in other working papers in this series. Variance is considered to be a basic and most important form of risk facing investors. By as little as a five-year holding period, investors can cut in half the pricing volatility in asset pricing.

With anything under five years, performance may largely be dependent upon luck and fortuitous circumstances. One investment professional believes that over short periods luck is probably more important than skill, with a large random element to pricing. It is only over a 3 to 5 year period that random events cancel out, leaving the net result of the investor's intelligence.<sup>12</sup>

Long-term investing, by definition, means low turnover of portfolios. This has the effect of delaying the realization of capital gains, reducing trading expenses and taxes, and most importantly, letting the asset compound in value. Whenever there is high turnover in portfolios, taxable impacts will occur, commission fees will be add up, and the magic of compounding interest will start to dissipate. The turnover rate tells an investor whether a fund believes in long-term philosophies. Anything greater than a 20% turnover, and the portfolio is in the short run, or at least the near-term.

In the short-run, possibly only one-third of a stock's price is due to earnings. The rest of the price results from so many short and near-term variables, including people's emotions (more on emotions a little farther into this reading). By the long-term however, possibly up to 70% or so of the price of any one stock may be due to a company's earnings ability.<sup>13</sup> By investing in the long-term, pricing volatility is smoothed out, and the full, measured value and worth of a business becomes evident. An investment's basic level of

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<sup>12</sup> From an excerpt of writings by James H. Gipson, quoted in *The Investor's Anthology*, at 74-75.

<sup>13</sup> In a computer run of 1,200 companies over an 18 year period, the correlation of earnings to price steadily increased from a short-term 3 years of .131 to .360, and up to an 18 year incidence of .688. *The Warren Buffett Portfolio*, p.74-76, and Appendix B.

risk also is smoothed out to the corresponding level of competition the company is experiencing. Short-term risk and sheer craziness gives way to long-term, low risk predictability of earnings, value, and worth of a business.<sup>14</sup>

Now, the long-term can be much longer than 5 years, say 10 to 30 years in length. These stretches of time are realistic for institutional investors that essentially see a perpetual income stream, but they are also appropriate even at the individual level. According to one author, one of the greatest mistakes an investor can make is to underestimate the holding period.<sup>15</sup> While a person may move out of a particular stock after five years or so, that same person may also move right back into another equity, thus maintaining his or her equity allocation percentages. When the ownership of *all* stocks is considered, a person with a long time frame may be looking at overall stock market performance for the next quarter century or more.

20 and 25 year holding periods are certainly within the purview of individual investors. Even older investors could still have long time frames. This is especially the case when the elderly patriarch or matriarch of a family wants to pass all of the family's stock to the children or grandchildren. In such an instance, the heirs of the family will ultimately be the ones to enjoy the measure of those longer frames of reference.

## **Invest in the Long-Term, Part II**

The above thoughts on investment over long time periods can be shortened down to two short sentences. They are the following:

***Investment occurs in the Long-Term. Speculation occurs everywhere else.***

Only in the long-term will an investor be trying to capture the accumulation of wealth and capital resources that is so very much part of our present-day economic experience. The investor wants to increase his overall wealth. Public and private corporations, as well as government and corporate bonds, are the vehicles by which such wealth can be accumulated and increased. It just takes time.

Conversely, with short and near-term perspectives, a person is not at all concerned with the gradual but incessant build-up of wealth occurring daily through basic economic productivity. The individual is only worried about the current pricing level of the security at issue. The person is merely speculating that the price of the stock will increase. Over a century ago, it was discovered that the mathematical expectation of speculation is zero, a zero sum game.<sup>16</sup>

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<sup>14</sup> A review of the S&P 500 long-term performance from 1964 to 1999 shows 2 principle things: First, the trend of earnings is strongly upward; Second, stock prices advances are closely aligned to earnings and dividend growth. *See, Winning the Investment Marathon*, at 10-15.

<sup>15</sup> Jeremy Siegel, *Stocks for the Long Run*, at 28-29.

<sup>16</sup> Louis Bachelier, "*The Theory of Speculation*", 1900.

Either people are seeking the fruits of long-term economic activities, or they are merely after the gains of short-term pricing increases. Either individuals are investing, or they are merely speculating. It is that simple.

### **Seek the Highest Return to Net Worth**

The priority of investment should be to maximize net worth. Every thought, each equation, and all actions should concentrate on the maximization of an investor's net worth position. This may sound rather simple.

Return means the total return that is ultimately given to the investor. As in post-tax, post-commission returns. Short-term gains are so quickly eroded by tax impacts and the costs of transactions. So many mutual fund and other investment counselors will trot out returns pre-tax, and pre-transaction cost. They are "tax-blind." Well, the individual investor is not. Taxes are a large concern to investors.

One shouldn't be overly concerned about hitting a target price in the sale or purchase of an asset, either. A target range is only one tool used to maximize the overall return on the investment, or to be more precise, the annualized compounded rate of return on all investments. The sale or purchase price of an investment is not the nirvana of finances. The post-tax, post-commission "net" annualized compounded rate of return to net worth is what matters.

But there are times in which the long-term approach will not return much. Times when the capital markets are very high in asset valuation. In such times, in order to maximize the return on investment, the investor has to seek out short-term opportunities. The long-term is preferable, but if asset pricing are so high that no more long-term gains can be realistically attained until the markets takes a dip, then the maximization of returns demands an investor look elsewhere.

The goal is not long-term investing, per se. It's just that long-term investing tends to maximize the gains, after considerations are made for risk and expenses. The goal over the long-term is to maximize the net return of investment and net worth of the individual. In many instances, this means investing in the long-term. But, the goal is the highest possible return on net worth over the long-term. And that return could come from short-term cash positions upon occasion.

### **Invest to Control the Future**

Investing is not a foreign, abstract term. It entails the control of economic activity and destiny at the individual level.

Many of the thoughts noted in this document come from simple things learned in the early years of one's life. Work very hard. Never spend more money than can be earned. Don't accept debt lightly, and pay it off quickly. Save like a squirrel burying nuts for a

very bad winter (a favorite expression among the senior citizens in some areas of the Midwest).

Many investment techniques are amazingly sophisticated, yet still revolve around sound, basic concepts. Invest in the long term, and invest regularly. Continually increase net worth. Never stop investing, even in personal financial downturns. Make calculated efforts designed to maximize gain without excessive risks. Develop an asset allocation, broad diversification, and risk minimization. And look at quality companies that are growing and are undervalued. Invest to Control the Future.

### **Invest Regularly**

Saving and investing on a regular basis produces tremendous gains over one's lifetime. To a large extent, it is simple matter of compound interest. Some call it the miracle of compound returns. By investing regularly, a person takes advantage of the simple, common sense school adage of compounding returns. Interest is received on the principle amount, reinvested, which will then add to the principle, which will then return even greater amounts of interest. And so on.

Regular investing can be done through dividend reinvestment. By reinvesting the dividends received from an asset, additional assets can then be purchased. The reinvestment is added to existing capital, (or basis, as accountants call it), and the next time a dividend is paid out, it is based on the higher amounts of assets that have accumulated. Reinvestment of this additional amount produces yet another round of heightened dividends.<sup>17</sup>

Another common sense thought: dollar cost averaging. Regular additions to capital will allow the individual to take advantage of the dips and peaks in asset pricing. This results in an average of all lows and highs in prices. By regular investment, the average price of the asset may be lower than if an investor bought it at one particular time.

Why is this? Because, people never know when an asset may suddenly dip or jump, buying a huge amount all at once may produce a higher or lower price than on average. Most people just seem to have an almost overwhelming urge to invest when the capital markets are very, very expensive. That urge will end up costing the individual when the market cools off, and the stock price come back into a more typical price range. By investing regularly, an individual resists the urge to invest when the market is hot and overvalued. The individual is investing in all kinds of markets, both hot, and extremely cold. Regular investment will therefore produce a lower average price of purchase than if purchased all at once, probably in a "hot" and expensive market.

Regular investment is done in good times and in bad times. Additionally, please don't be too worried over the specifics of an investment. A good return on any investment has more to do with the allocation between equities and bonds than anything else.

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<sup>17</sup> Investing regularly and reinvesting all earnings and dividends are 2 of the 4 basic principles of the NAIC. See, *The Official Guide of the NAIC*.

Many people will ask how is it possible to save and invest anything when it takes all their salary to merely live on. Investing involves choices. If one wants to live in the largest house in a city, that is a choice. But chances are that investment will not occur regularly, unless the salary is quite large. The individual may be simply expressing a pattern of current consumption. And there is nothing wrong with that. It makes the economic engines of the world go round.

But, unless there is a huge inheritance or large economic windfall, a consumption pattern will never enable people to have significant economic resources at their disposal. Consumption gives some great creature comforts, but it will not provide economic power at the individual level. Only investment will do that. Investing is really a matter of deferred consumption – a person chooses to not consume in the current time period so that consumption can then be greater in future time periods. It is therefore a choice between current consumption versus consumption deferred until a later date.

### **Living Below One's Means**

The simplest way to invest regularly is by living below one's means. Life is full of daily choices. Does one consume today or not? By not immediately consuming, and instead saving even a few dollars a week, a person is moving towards an investment philosophy.

Many people that look wealthy really aren't. They are merely into a huge spending pattern. The Economists call them "conspicuous consumers." Big cars, powerboats, expensive homes, condos at a lake add up to high expenses. Many professionals, even financial professionals only appear to be wealthy. In reality, they have very little net worth. Some have massive debts, in fact.

A person with a decent job though, can become a first class investment wonder. He or she provides for the kids, has a nice home, and shops at Wal-Mart and K-Mart. Every week, a few dollars are stashed away here and there. Every month, a few more dollars are placed into the retirement accounts, possibly with some employer matching. These people are living below their means. They spend less than they have. They save the rest. They are investors. They put the kids through college, too, but always find enough for their own personal savings. And they will have a future, with net worth and cash for retirement. Then they can consume, and enjoy. Merely by living below their means.

The following is a wonderful example. Tom O'Hara was the founder of the National Association of Investors Corporation, or NAIC, which was started in 1951. Mr. O'Hara was fond of going around the countryside, preaching on the merits of long-term investing. He would talk to just about anyone who would listen. One day, O'Hara gave a talk to some youngsters. He told one of the children that if he regularly and faithfully invested just \$25 a month, the child could someday grow up to be a millionaire. Now, \$25 a month can be saved by most people, even individuals that do not earn much. That one child listened very attentively.

Some 40 years later, Mr. O'Hara was still giving speeches. In fact, by this time, O'Hara was considered the dean of the investment club circuit, and was truly world renowned for his beliefs of long-term investment at the individual level. O'Hara was giving a talk at a NAIC seminar. A man walked up to O'Hara, showed him his personal investment portfolio of \$1.3 Million, and simply said "You Were Right." Ever since he heard O'Hara speak 40 years before, that same boy dutifully invested \$25 a month. He grew up, obtained a job, had a family, and developed a million dollar plus portfolio, all on \$25 a month. An amazing story.<sup>18</sup>

So, invest a little. Or invest a lot. But just invest.

### **Invest in Businesses**

Investors should invest in businesses, and not the stock of that business. This deceptively simple saying belies a deeper thinking pattern. Most analysts will talk in terms of earnings per share, estimated growth rates of those earnings, and target price ranges over the next 6 to 12 month period. Most public businesses will discuss the same things, too. Everyone seems fixated on EPS reports, and where the stock price is heading in the next few months.

By concentrating on the fundamentals of the business, the investor gets away from the earnings per share race. The focus is on the business itself, its management structure, its future growth planes, the competition, the products of the company, customer satisfaction, employee productivity, and everything else of relevance to that particular business. The number of shares is useful only at the end of the analysis. Divide the expected future cash flow stream, after discounting to present value, by the number of common shares outstanding to produce the value of the business on a per share basis.

The concept of investing in a business-like manner goes back to Benjamin Graham's earliest writings in the 1930's. In a famous quote, Benjamin Graham believed that "Investment is most intelligent when it is most businesslike". Buffett also looks at the business, not the stock. Others also recommend buying businesses, and not stocks.<sup>19</sup>

By investing in the business as a business, the investor begins to realize that he or she owns a part of that business. The investor has a vested interest in the corporation and its profits. The investor becomes a part owner of that business activity, most assuredly as much as if the investor would be a partial owner of any private firm. The investor then takes nonsense of the management in a rather personal manner. It is the investor's money being squandered when the managers of the business spend millions of dollars on business parties in lavish surroundings. And it's the investor's money being wisely deployed when the managers spend money on redevelopment of the capital plant in order

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<sup>18</sup> The story is recounted in *Investing For Life*, at 82.

<sup>19</sup> *The Intelligent Investor*, at 286; *Buffettology*, p. 33; *Warren Buffett Way*, p. 75; See generally, Phil Fisher, *Common Stocks and Uncommon Profits*; Lowell Miller, *The Single Best Investment*, at xv.

to maintain or expand capacity (assuming, of course, there is demand for the products produced by the capital in the first place).

By thinking of the business as an ongoing, thriving concern, the investor pays less attention to the daily stock price gyrations, and will instead focus on a meaningful valuation of the entity. That will work to the investor's long-term benefit.

Buying a share in a business amounts to an investment in the wealth building and capital accumulating activities of that business. In turn, the business exists to enhance cash, capital, and wealth to its legal and economic structure. The investor grows wealthier at the personal level, because the value of the business increases. Contrast this with owning a stock – you only care about the price of the stock, not its overall wealth. The efficiency advocates will proclaim that the value of the underlying company will be fully and quickly made part of the stock pricing. With business ownership, one does not particularly worry over momentary pricing support levels. The investor only is concerned with its ability to generate wealth. When a small share of a publicly traded company is purchased, please realize that the investor is becoming part owner in the business.

### **The Preservation of Capital and Wealth**

In the world of finance and investment, the “have's” from the “have not's” are easy to determine. The people that don't have much money, but have an incessant urge to possess cash quickly, are likely to be the ones talking about maximizing their rates of return from investment. People with hordes of money won't be overly concerned about the rate at which they are amassing their wealth. They are simply concerned about keeping their wealth intact. It is not how fast you can make money that counts, it is how much of it can be kept that becomes the critical issue.

Wealth is difficult to come by, even in the best of circumstances. Normal and daily competitive pressures will tend to eliminate the excess returns of any one business over the course of time. Mistakes of business judgment or lack of business acumen will often cause an economic loss even in situations with superior product development or excellent location of business. Once the obstacles are overcome and wealth is accumulated, the real challenge then sets in: to maintain and preserve that wealth. The wealthy businessmen or businesses may become a target for attacks by other companies or individuals bent on achieving some measure of prosperity. The motivations and desires of succeeding generations of individuals may also change and shift. There are many tales of hard working business-people leaving their entire wealth to their children, only to have those children never be able to succeed on their own. In other cases, children and grandchildren of the wealthy set may simply want to live the good life, and enjoy the cash reserves. And why not, it is their money to spend. Poor house, to big house, and then to poor house once again all in three generations, is an oft-repeating pattern among many families both in America and abroad.

Many investors will be greatly concerned about the preservation of wealth. Long-term investors will tend to be more focused on maintaining and continuing their asset patterns

than on anything else. A conservative investment program therefore may be all that is necessary for many individuals operating in very long-term time frames. So what if a person barely broke even in any one year in the public capital markets? It could have been a lot worse - as in a 25% decline in each year for three or four successive years, until little of the original wealth is left. Breaking even may be preferred in such circumstances. At least, the capital is left intact and preserved for its enjoyment and use.

The preservation of wealth might be a conservative goal. A far greater amount of wealth would be in existence today however, if many individuals had not taken foolhardy and overly aggressive risks to increase their momentary and very fleeting returns from investments.

### **Psychology and Behavior**

The thinking pattern of individual investors can be wonderful at times. The philosophy of investing becomes an incredibly powerful force, if aimed in the right direction. Individuals being what they are, however, mistakes in the thinking processes can and do develop.

Benjamin Graham wrote a half of century ago about “Mr. Market.” Imagine that you, the investor, are a partner in a business with a man by the name of Mr. Market. Everyday, Mr. Market is either tremendously excited about investment prospects, or extraordinarily depressed concerning the smallest of details. And, of course, Mr. Market continues to sell and buy stocks throughout his emotional ups and downs. If other investors continue to sell and buy from Mr. Market, even though he may be quite volatile and emotional from day to day, the investors may be prone to mistakes in the thinking pattern, almost the same as if the equity market itself is making some basic miscalculation.<sup>20</sup>

More recently, Charlie Munger has given discourses on the psychology of misjudgment. People become overconfident. People have overreaction biases, whereby they overreact to bad news and under-react to very good news. Investors experience loss aversion, wherein they cannot part with a bad company, even after they know better. People become more risk tolerant in good times, too, when they should become more cautious. They become frightened of new investments in bad times at precisely the time when they should be buying aggressively. Munger even has gone so far as to advocate a two-track thinking process. He does the traditional calculations with Buffett on what companies to invest in, but then he asks himself what mistakes have occurred in his own thinking pattern. In realizing that even the best investors in the world make mistakes in cognitive processes right alongside very competent financial analysis, at least the misjudgments possibly could be isolated and dealt with.<sup>21</sup>

The psychological component of investing becomes especially pronounced when a sale of a stock is contemplated. In many instances, the time to buy an equity is fairly clear-cut

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<sup>20</sup> Graham mentions Mr. Market at 108-109, *The Intelligent Investor*. A good summary of Mr. Market can be found in *The Warren Buffett Portfolio*, p. 143.

<sup>21</sup> Munger’s thoughts are summarized in *The Warren Buffett Portfolio*, at 145-146.

– i.e., when the stock becomes undervalued with respect to its intrinsic valuation levels. But a decision to sell often times will take on a highly emotional character, since the sale point may be more murkier. Individuals become overly attached to a stock, so a sale does not occur when fundamentals clearly warrant it. Additionally, regret is a powerful emotion. Many people would rather avoid selling the losers than admitting to an investment mistake. It is no wonder that people are much more likely to sell their winners than their losers. There is also a perverse sense of pride that ties us to our own mistakes. Researchers call this the “endowment effect”.<sup>22</sup>

Academics and analysts both agree that earnings are a crucial determinant in stock prices, but professionals often will have a hard time accurately projecting future stock prices based upon short and near-term considerations. Academic studies have shown that in the short and near terms, earnings may only account for a correlation of 35% or less to the company’s stock price. The price of a stock is affected by so many others things short-term, such as interest rate adjustments, but also to people’s emotions and misjudgments. In the long run however, earnings correlate to stock prices up to 69% of the time. The real value of a company, and its worth as an entity, comes out only in the long run.<sup>23</sup> Mistakes in individual thinking patterns will keep investors from accurately understanding near-term situations, thus making the markets rather chaotic at times.

As investors go about their business, there should come the realization that normal thinking patterns contain misjudgments. Even among the Charlie Munger’s of the world, there will be two tracks of thought – one very rational and orderly, and the other, rather emotional and volatile. This is not Dr Jekyll and Mr. Hyde. This involves the normal, everyday patterns of thought simultaneously developing both brilliancies and blunders. It is up to each investor to become aware of the cognitive processes involved, and then try to and sort out and isolate those biases and misjudgments.

Many people have extensively written on cognitive mistakes. Charles Mackay wrote on crowd psychology and “The Madness of the Crowds” more than 150 years ago. David Dreman has done groundbreaking work on the psychology of investors.<sup>24</sup> He believes that many analysts will extrapolate earnings projections using linear methods, even though studies have shown that complex judgments involving numerous variables are better analyzed using a configural processing method.<sup>25</sup> Most individuals are just unable to think in complex terms – they tend to break the task into simple, sequential steps that are more easily understood.

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<sup>22</sup> Many of these items regarding the sale of equities are noted in “Seller’s Remorse”, Personal Finance, July/August 2002, p. 72, Maggie Mahar.

<sup>23</sup> *Warren Buffett Portfolio*, at 75-76; & 218-222, ran a computer study of stock pricing performance correlated with earnings, over various time frames. For a 3 year period, the correlation between price and earnings ranged from .131 to .360; for an entire 18 year period, the correlation was .688.

<sup>24</sup> MacKay wrote *Extraordinary Popular Delusions and the Madness of Crowds* in 1852. Dreman wrote *Psychology and the Stocks Markets* in 1977. Many thoughts in this section come from Dreman’s *Contrarian Investor Strategies*.

<sup>25</sup> Dreman, at 103.

People are commonly biased in several directions all at once. They are too optimistic during good times, and too pessimistic in bad times. Most individuals are overconfident of their chances of success, and overestimate their degree of knowledge. Cognitive illusions are not easily unlearned. Ingesting large amounts of information can actually lead to worse decisions, not better ones. We react to only a small amount of information and then exclude any conflicting data that does not fit into the investor's mindset. More information does not guarantee more accuracy. Indeed, at times, the avalanche of information upsets and prevents accurate decision making at the individual level.

It is not just lay individuals that make mistakes. Experts will error predictably and often. Cognitive biases can even be reinforced by the experts. One study from 1954 showed that statistical methods outperformed professional clinical observations in every single case. Another study indicated that the best predictor of success at the college level was a simple statistical sort for high school GPA and college aptitude tests. Qualitative scores from college admission officers were much less predictive.<sup>26</sup>

Experts and lay folks alike will adopt shortcuts and rules of thumb rather than calculating the actual odds. Selective processing occurs on a regular basis. People intuitively apply their own mental statistics. Hindsight bias impairs the proper assessing of past errors and prevents learning from those mistakes. Many of these problems in thinking patterns have been noted in various academic papers. These include a fear of regret that is stronger than the joy of a success; something called "cognitive dissonance", which is the minimization of the conflict between what an investor knows versus what the investor actually does; a technique referred to as "anchoring", or mentally fixing on recent events; the feeling that a few characteristics define a "representative" view of the world; and a risk aversion that is compulsive in nature.<sup>27</sup> Other thinking patterns that have also been noted include looking at problems in pieces rather than in the aggregate; a split in the human psyche between wanting order versus desiring immediate satisfaction; and the above noted endowment effect whereby we value what we own more than what we would pay for the very same item if we were initially purchasing it.<sup>28</sup>

This all results in irrational investor behavior. The vast majority of investors are simply overwhelmed by their own human nature. Dreman even believes that emotional biases and overreactions occur in such a steady and predictable pattern (with investors consistently overvaluing hot stocks, and just as consistently undervaluing the weaker price performers) that a value investor can take full advantage of the emotional patterns. Buy out of favor stocks, and then sell when the businesses become the darlings of the finance community.

A very thorough treatment on the matter has been conducted by two Israeli psychologists. Daniel Kahneman and Amos Tversky have been running surveys and writing about them

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<sup>26</sup> *What Works on Wall Street*, at 12-13.

<sup>27</sup> All of these psychological errors have been studied in an April, 2000 article of the *AII Journal*, written by R. Douglas Van Eaton, and summarized in "Investors Can Drive Themselves Crazy", *St. Louis Post Dispatch*, May 8, 2000, p. BP8.

<sup>28</sup> *Against the Gods*, at 289-295, refers to several studies and researchers on these items.

since 1979. They note that people's emotions tend to destroy self-control, and have cognitive difficulties in fully understanding what they are dealing with in times of stress. They produced a rather large body of papers and survey results that they dubbed Prospect Theory".<sup>29</sup> The general field of research has become so important that it is now referred to as Behavioral Finance. Some of Kahneman and Tversky's surveys show that people are not risk averse in some situations. Surveys suggest that people generate inconsistent results, depending upon how the choices are framed. When facing uncertainty, many individuals will display a continual pattern of irrationality and inconsistency. People use mental shortcuts to deal with complex situations. While believing that total rational thought may not be completely possible in individuals, people can nonetheless make orderly choices, although not always rational ones. Kahneman's work has become so famous over the years that he recently was awarded the Nobel Prize in Economics, a great feat for anyone, let alone a psychologist.

Psychological forces at the individual and group levels produce biases and mistakes in investor behavior. It is up to each investor to understand the processes by which these mistakes occur, then to sort them out, and adjust thinking patterns accordingly.

### **Probabilities and Behavior**

Psychology and behavior can be taken one more step, into the probabilities of an investment by professional level investment managers.<sup>30</sup>

Successful long-term investors tend to automatically sort through probabilities of occurrences in their investments. What is the probability of a new, competing product being offered by another company? If such a product does appear, what is the expected loss in future revenues streams to the company under study? Does management have contingency plans in place for preserving market share in the event of heightened competition? Is management engaging in current R&D to launch their own new products, in an attempt to actually increase market share and profitability? As new information is received on the competing company and its products, has management in the past reacted, or just ignored the threat? Can the company continue to outperform the competition over the long haul?

Probability theory has a definite place in the market as a whole. It's called complex adaptive behavior.<sup>31</sup> Over time, equity markets will go through changes in their fundamental structure and make-up. In essence, the entire capital process will adapt to new circumstances. For instance, the S&P 500 Index was heavily weighted 30 years ago towards utilities and smokestack industries. Today, it is filled with Tech and Finance companies. The markets change over time, and rather automatically, too – all in response to changing circumstances. It is the environmentalist's GAIA theory of the Earth, applied to modern finance principles. The Earth is alive, or at least the complex environmental systems change in response to external stimuli, such as pollution.

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<sup>29</sup> A good review of Prospect Theory can be located in *Against the Gods*, at 270 to 285.

<sup>30</sup> *The Warren Buffett Portfolio*, p. 111 and following, contains a nice section on numbers and probabilities.

<sup>31</sup> Robert Hagstrom, *Id.*, has a great chapter devoted to complex behavior, at 161-185.

It is as if the public capital markets are alive too, at times. The markets adapt and change over time, in response to external stimuli of changing economic preferences, desires, and needs all expressed at the individualized level. What is the probability of big trading houses extending their hours of active trading? With the appearance of the Internet, what becomes of those big trading houses if they do not offer after hour trading? The market adapts and changes, within a very complex system. Good investors think in terms of adaptive behavior. Probabilities and adaptive behavior becomes par for the course.

With such complex interactions in the capital asset markets, the direction of price changes, let alone the extent of those changes, becomes rather unpredictable. People's emotions run wild, and the interactions of those emotions produce extraordinary volatility in short time frames. Complex behavior suggests a seething, tumultuous, emotionally pitched, roller coaster of a ride in the capital markets and to the stock prices from day to day. The model almost demands it, in fact. No one should really be shocked by a sudden 508 point drop in one day of active and turbulent trading. Unpredictability is very much to be predicted within a financial model based on complex behavior that is constantly adapting and changing to external stimulus. Change, and the unpredictability of a change, is highly probable. Everything changes in a very unpredictable manner.

Over the long haul, however, the wild gyrations to this ride of adaptive activity will smooth themselves out. The behavior will become much more predictable to anticipate. Expect the unexpected, in the here and now. Anticipate and count on probabilities and degrees of confidence over the course of events and length of time. One text goes so far as to state that psychology, and not finance, provides the basic rules for successful investment in the short-run, but that business fundamentals govern the equity markets in the long-run.<sup>32</sup> Other working papers will draw upon these comments in a discussion of probabilities in investment analysis (2006:Summary) as well as formulating a changing measure and meaning of risk over time (2006:8).

### **The 3D Viewer**

Back in the 1950's, a little device was quite popular with the movie audiences. It looked a lot like a pair of sunglasses, only worn in the movie houses. It was called a 3D Viewer, and it allowed the theatergoer to see the screen in three dimensions. Nowadays, the technology has been updated with impressive holographics. Any major entertainment park will likely have a movie projection with some dazzling 3D abilities. But the general concept is the same as so many years ago.

Great long-term investors of today have a dimensional view of investing, just as the movie attendees of yesteryear had such a view of the movies. Only the investors will visualize the three dimensions of risk, return, and time, instead of three spatial dimensions.

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<sup>32</sup> *Winning the Investment Marathon*, at 200; The same book has a nice example of ADP, a company with very consistent, predictable earnings, but with major stock price advances and then declines of up to 41% over a 36 year period. *Id.*, at 145-150.

Modern Finance theories revolve around one central belief and guiding principle: the risk-return trade-off. Indeed, the starting point of current investment theory begins with this one trade-off. Risk and return are core foundation items in Finance.

Core values they should be. Risk can be measured in many different ways, and it can take on many different meanings. Return can be many different things to many different people, as well. But, most people will want and demand a higher return for having to assume higher levels of risk. Put another way, a higher rate of return is necessary in order to induce capital formation into assets with greater risk levels.

This is really no more than a simple two dimensional matrix. X and Y coordinates, fitting neatly on a graph of risk versus return. A few short pages ago, it was noted that analysts will typically use linear projections when they should have been analyzing numerous variables through configural processing methods. Instead, the professionals will logically go step by step, sorting out one variable at a time. Most people possess the ability to logically and deductively sift through large quantities of information. The intuitive process, involving large leaps of logic, will be baffling and even repugnant to many professionally trained finance types.

Two dimensional, linear logic can amount to an intellectual mistake. John C. Bogle believes that two other variables also come into play. Cost and time are relevant factors, too. All four variables are mutually dependent upon each other. They affect each other, and cause each variable to change as another variable is studied and analyzed. He calls it a four dimensional analysis. The finance literature is replete with detailed discussions of risk and return, but is severely lacking in considerations of cost. Many mutual funds deliberately and quite consciously ignore the cost side of the equation. They are all too willing to assume cost away, leaving only a two dimensional sort. But the cost variable, Bogle feels, is the single most important determinant of performance. Costs are possibly even more important than are either risk or return. The surest way to have top quartile performance is to have bottom quartile expenses.<sup>33</sup>

Costs produce so large of an impact on the risk versus reward exchange that the entire risk premium of a stock can be wiped out by various cost factors. Using historical data for a 40 year period, a 12% growth of a mutual fund pre-cost would have generated a 10% post-cost growth rate. This is due to expense ratios averaging 1.5% and transaction costs .5%, for an average total cost of around 2%. A 12% return for 40 years may generate \$931,000 on a \$10,000 initial investment, whereas a 10% return produces a terminal value of \$453,000. Worse yet, after tax impacts are considered (from the capital gains generated through high turnover rates), the terminal value may only be \$217,000.<sup>34</sup> Costs and taxes are therefore crucial factors to consider before taking on any risk for any given return.

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<sup>33</sup> *Common Sense on Mutual Funds*, at 91. Bogle is famous for the slogan "Cost Matters".

<sup>34</sup> *Id.*, at 310-314.

While Bogle feels that costs are separate components of any risk and return analysis, the argument can be made simpler by just treating costs as critical factors of the return variable. The only return that matters should be considered as the post-cost and post-tax, type of return. All other references to “returns” are illusionary at best, and deliberately evasive at worst. Many financial professionals are tax-blind when it comes to performance characteristics of a portfolio or a fund. Most investors are not tax or cost-blind, however. A net return is the only type of return that is of any great consequence.

Many great investment minds also feel there is more to making money than just balancing risk and return variables. The X and Y co-ordinates do not adequately explain the complete investment universe. Another dimension of factors must be considered, as well. Time is the third critical variable. Successful investing involves a dimensional thinking process (see, the above comments on complex adaptive behavior). It almost becomes an intuitive approach at times. The strict deductive logic of incrementally affecting one variable at a time while holding all other variables constant gives way to mutual and simultaneous interdependence between all variables. It is the configural versus the linear method at work. All factors mutually and simultaneously affect all other factors. One variable cannot be assumed to be fixed, while another is simply adjusted. All factors, at all times, are fluid and are subject to constant revision and co-dependence. This is somewhat similar to a statistical tool called dynamic programming, where several variables simultaneously must be solved.

Certain minds will see investment decision-making in such a dimensional way. They will simply and automatically think in three dimensions. X, Y and Z are all critically important, and all at the same time. Such minds see a triad of variables at work. In seeking out and finding an answer to the risk and return analysis (or any other economic equation, for that matter), such minds visualize a three dimensional cube instead of a two dimensional graph. The thinking pattern for great investment decisions, may be dimensional in nature.

In the next few paragraphs, there is a general suggestion to keep things simple. A consideration of only X versus Y ends up being too simple, however, in the world of finance. Risk and return cannot be fully understood without also considering the impact of time. We live in a three dimensional world of risk, return, and time. The equation can be solved by reference to a triad, to a three-dimensional plane of thought and existence.

Once time enters the investment picture, the matter can become quite involved. Liability streams and utility factors also become critical in the overall determination of whether time has a small or large impact on risk and return concepts. Working paper 2006:Summary goes into great detail on the impact to portfolio analysis from the introduction of time horizons.

Actually, risk and return may not only be time correlated, they merely are pricing-related expressions of utility maximization being expressed at the investor level. When the door of time opens in the world of Finance, the entire manner in which we view investments fundamentally shifts. It no longer is a simple question of risk versus return. In what Time

horizon? With what utility? What are the liabilities? These become relevant and important questions.

### **Keep It Simple**

Investing in businesses should not be an overly complicated task. It all comes down to sound financial and business practices. Have a good product to begin with. Develop consistent and intensive marketing efforts. Treat each customer as a close, personal friend. Be fair to employees and customers alike. Keep the cash flows going. Have stable to increasing returns on equity, assets, and investments. Keep costs down. Keep revenues up. Word hard. Be honest and forthright. Above all, put more value back into the business than was ever pulled out of it.

Unfortunately, so many finance professionals make things so complex. They start to look at alphas, betas, mean co-variances, and frontiers of risk-return optimization. Let alone technical analysis wave theories. They are not satisfied with a decent return. They want something that is running so far ahead of the market that it can't possibly keep going at that pace for very long.

The finance professionals may appreciate the subtleties and nuances of all of the mathematical and theoretical discussions. But it is entirely another matter for that same finance set to actually utilize the material in any coherent pattern. Armed with so much statistical data and modern finance theory, finance graduates promptly run through all their theories and data-bases to make individual asset selection. But, 90% of the managers hired by the Mutual funds will end up under-performing the S&P Index, and by some wide margins over long time frames. Knowing all this, other professionals have suggested that simplicity is itself an effective strategy for long-term investing.<sup>35</sup> Some writers even mention "Occom's Razor", a parable whereby the simpler the explanation, the more likely it is to be correct. The name comes from a 14<sup>th</sup> century monk, William of Ockham, who generally concluded that the simplest theory is usually the best.<sup>36</sup>

While useful, the complicated theories of modern finance are not absolutely critical for success in the business world. The finer points of Finances may actually prove to be a hindrance to that success. It makes one lose a basic, common sense perspective of successful business activity. Academic knowledge is absolutely necessary. We continually need to expand knowledge of ourselves and our own business activities. But, the basics are all that are needed for the identification and ownership of successful businesses. Everything else can get in the way. Many deca-millionaires don't even have a college education. They merely have a good product on their hands. They work day and

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<sup>35</sup> Numerous writers have suggested over the years to keep it simple. *Common Sense on Mutual Funds*, John C. Bogle, 1999, at 83; James P. O'Shaughnessy, *What Works on Wall Street*, at 17; John Neff, *John Neff on Investing*, at 51; *The Single Best Investment*, Lowell Miller; Charles Ellis, *Winning the Loser's Game*, at xii.

<sup>36</sup> Bogle, at 33. Ockham's Razor (with a different spelling) is also mentioned in *What Works on Wall Street*, at 17.

night to deliver that product to the marketplace in a timely and cost-efficient manner. So, keep it simple in all investment and business ownership decisions. You will do just fine.