Save and Invest

The habit of saving is itself an education; it fosters every virtue, teaches self-denial, cultivates the sense of order, trains to forethought, and so broadens the mind. – Theodore T. Munger

Whether we want to work for a company or start one, all of us will one day face retirement (or at least a slowdown in our pace). Setting aside adequate funds for this stage during our most productive years is crucial. It is astonishing how many people seek to take out loans against their retirement accounts or against their homes to pay for something in the present. Anything short of a medical emergency should never warrant such action. It takes many years to accumulate enough savings to provide an income for us when we are old. Raiding it when we are young will almost certainly cause great pain later on.

Because of the boom in the stock market during the last few decades, many people saw their retirement accounts grow far faster than they expected. This gave them the idea that increasing one's wealth was relatively easy. But historically, returns from the stock market have been moderate at best. Over the past 200 years they have averaged only about eight percent. Returns from bonds have been even less. Therefore, once surplus funds have been set aside and dedicated to retirement or a college fund, they should be guarded diligently.

Americans as a whole have one of the lowest savings rates in the world. Two thirds of our economy is dependent upon consumer spending. Businesses and even the government will therefore encourage us to keep spending to keep the economy running. The only way to succeed in setting aside funds for the future will be to completely tune out this propaganda. We have become a throw away culture. It is easier and often cheaper just to get rid of something than to have it fixed. We are also continually pressured by society to upgrade to newer and better versions of our cars, computers, appliances and electronics. Learning how to repair things or live with them in a less than pristine state is the only way to keep our surplus funds from being constantly absorbed by new purchases.

Ideally, we can set aside a regular amount from our paychecks that will go straight into a retirement fund. Most banks will allow us to set up an automatic transfer from our checking to our savings account. When an employer offers to match contributions to a 401k account, we should make every effort to contribute the maximum allowable amount (not doing so is refusing to accept free money).

Virtually everyone would like to retire early. Who would not? Work is just that—work. This does not mean that our labor cannot be enjoyable or fulfilling. It can and should be. But most of us naturally prefer to set our own schedules and do what we want when we want. It is very tempting to seek out a quick pathway to this desirable destination. Many people attempt to find a shortcut by speculating with their savings—either by starting a new business, investing in someone else's, or picking a winning stock. The few that have succeeded in doing this are lifted up as an inspiration for the rest of us. But the winners in this lottery are very few, and gambling our savings in this way is a dangerous game.

On the other hand, it is very important to maximize the returns that our savings will generate over a lifetime, as only a few percentage points can make a drastic difference in the long run. Therefore, finding the correct vehicles for storing our surplus funds is critical. We will need to strike the right balance between risk and rewards.

There are four primary vehicles for storing wealth, which the financial industry refers to as asset classes: stocks, bonds, commodities (such as gold), and real estate. Stocks and bonds are the primary component of many retirement accounts. Stocks have historically provided higher returns than bonds, but they are also considered more risky. Returns from stocks usually come from capital gains, or increases from the purchase price that are realized when the stock is sold. Bonds provide interest income just like a savings account at a bank.

Stocks and Bonds

A traditional formula for balancing an investment portfolio recommends pegging the percentage of savings allocated to bonds to your age. For example, a 30-year-old would invest 30% of his savings in bonds and 70% in stocks. The bonds would give some insurance against loss of principle, but the stocks would provide greater growth potential over a lifetime. A younger person could weight his portfolio more heavily toward stocks, since he would have many more years to work and could recover more easily from a loss of principle if the stock market went down. A 70-year-old, on the other hand, should place 70% of his portfolio in bonds and only 30% in stocks, since he would be much more dependent on the income from the bonds and could not afford to take a substantial loss if the stock market went down in value.

Although this formula seems reasonable on the surface, it reflects an incorrect philosophy about stocks. It should be remembered that stocks represent shares in an actual business enterprise that is making money. When you buy stock you are becoming a partial owner of a business. The market itself is irrelevant. It is just the place where you must go to buy the shares. Once the shares have been purchased, however, you should leave the market and not visit it again unless you want to buy more stock or need to sell some. Many people who buy stocks have lost sight of the connection between their shares and the businesses they represent. Stocks have become electronic symbols that constantly move up and down in the daily trading that takes place in the market.

Even many professional investors keep their eyes glued to the ticker symbols and are constantly trying to predict whether the price of a stock will go up or down. But, in spite of what many investment professionals claim, accurately making such predictions is impossible. Trading in and out of stocks is almost certain to produce losses or greatly diminished returns in the long run. Buying a stock is buying part of a business. Such a decision should not be taken lightly and once the purchase has been made an investor should stick by it through thick and thin, as long the shares pertain to a good business that is profitable. What the market thinks the business is worth on a daily basis doesn't matter.

Imagine, for instance, that you purchased your dream home for a good price. The value of the home might go up or down depending on fluctuations in the real estate market, but over many years (provided that the home was well-built and was located in a good neighborhood) the value would almost certainly go up. If real estate agents knocked on your door every day offering to buy the house for different prices (sometimes higher and sometimes lower than what you paid for it) you would just ignore them. This is the proper attitude to have toward a stock you have purchased. Obviously, a decision to buy part of a company in the first place should be based on a thorough investigation. The business should be profitable. It should be large and stable with a dominant market position. It will be much easier to gauge the strength of a company that sells products and services that you are familiar with. But you should also look at the basic financial data that will be available on many free financial websites.

When a company is making a lot of money, it should be paying that money out to the shareholders in the form of dividends. If you and a partner opened a restaurant together, you would expect to divide up the profits after all of the expenses had been paid. If you were trying to expand and open up a restaurant at another location you might opt to hold back some of the profits to pay for the new opening. But imagine how you would feel if your partner decided to use the profits to pay himself an exorbitant salary. You would obviously not tolerate it and would exercise your rights as a shareholder to either use the profits for growth or divide them up evenly.

Many large companies pay their CEOs exorbitant salaries instead of paying out the profits to the rightful owners—the shareholders. It is certainly tolerable for a company to use its retained earnings for growth—this will ultimately make everyone's shares more valuable—but handing them over to the CEO (no matter how good he or she supposedly is) is not fair to the shareholders. Firms that engage in this practice should be avoided by investors.

But when a company is making money and the profits are used wisely, owning shares of its stock can be far more lucrative, and even less risky, than owning bonds. As long as you have the discipline to ignore the ups and downs of the market, your returns over the long haul should be much better than what you would make from interest payments if you held bonds. If a company or a government issues bonds it is because they do not have money. They need someone else to give it to them and they are willing to pay for the favor. Companies or governments that really need the money badly and are in dire financial straits have to pay more to get a loan—just like an individual does. But why would you put your savings at risk for them?

There is always a chance they may default and you will lose everything, as happened to the owners of General Motors bonds in 2009. Municipal bonds are not necessarily safer, as even cities can declare bankruptcy and many are currently in danger of doing so. Treasury Bills have traditionally been considered the world's safest investment, since the U.S. government can always print more money to make the interest payments if it needs to. Unfortunately, the government has already printed enormous quantities of money to pay its bills. This policy has always led to inflation in the past.

Treasury Bills pay very little interest, and what little they do pay will be offset by a continual rise in prices. If the inflation rate is 5%, $100,000 will lose $62,000 of its purchasing power in 20 years. Thus, the interest rate paid by Treasuries would need to match the inflation rate just to maintain the purchasing power of your investment. So if you invested $100,000 and inflation remained at 5%, at the end of 20 years you would need to have accumulated a total of $162,000 to be able to buy the same amount of goods and services with it.

The stocks of companies that have the power to raise their prices as their costs go up will fare best during times of high inflation. For example, companies that make food products or medicines will probably be able to keep raising their prices, since people will need to buy these things no matter how much they cost. On the other hand, companies that make electronic gadgets may be in trouble, because if they raise their prices too much people won't buy them anymore. So, as a hedge against inflation, bonds are a bad bet, but stocks that have pricing power can provide at least some security against losing the purchasing power of your savings.

Gold

Another strategy to fight inflation is to invest in gold. Throughout history, owning gold has always been a way for people to protect themselves from high inflation and economic uncertainty. Today many people are trying to speculate on the price of gold. They closely follow the market fluctuations and attempt to buy when they think the price is low and sell when they think the price is high. But accurately timing the markets, whether one is investing in stocks or in gold, is impossible.

Those who want to buy gold should do so with the intention of storing it in a bank safe deposit box or a home safe and then forgetting about it. If it is safely locked away for many years it will probably be worth much more (in dollar terms) if it ever becomes necessary to sell it. Buying gold ETFs or having it stored without taking physical possession of it yourself is not advisable, as you may not ever be able to actually get your hands on it if a financial crisis becomes extremely severe. Silver can be a good alternative for those who cannot afford gold, but its price tends to be more volatile. Having at least some of your portfolio (but no more than 5%) set aside in precious metals can protect against inflation and provide peace of mind.

Real Estate

...Americans have finally rediscovered what their parents and grandparents knew. Specifically, that you buy a place to provide shelter and if it happens to appreciate well, that's an added benefit. Don't treat it like an ATM and don't count on it to fund your retirement. —Tom Lindmark

In previous decades, many people saw the value of their homes rise considerably over their lifetimes. They also tended to avoid taking out second mortgages and home equity loans, so that over time they steadily built up equity. After thirty years, the first mortgage on the home was usually paid off and people had a real asset that was usually a substantial portion of their net worth. Unfortunately, everything has changed in recent years. People took out so much money in loans against their properties that they lost most of their ownership stake. They were really more like renters than homeowners.

During the real estate boom, the values of properties were increasing so rapidly that people started speculating and buying homes with virtually no money down and then attempted to flip them for a profit. It seemed sensible to take out a second mortgage and buy another home with it because then you could have two properties that would go up in value. But when the crash came and home values plummeted, many people were left holding multiple homes that they had to keep making payments on, but without having real equity in any of them. The only way out for a lot of them was bankruptcy.

A home is a place to live, and for a family with children a house can provide a much more enjoyable experience than living in an apartment. For most people, paying all cash to purchase such an expensive asset will be impossible, making a mortgage unavoidable. But it should be remembered that paying cash would be ideal, as even a mortgage with a low rate of interest means regularly taking some of the money you have earned and paying it to someone else instead of saving it. The financial industry would like to have us believe that even if we could pay cash, we would be better off making the interest payments and investing our funds in something else. Supposedly, we could make money on the spread between the interest we would be paying to the bank and the return we would make on the investment. In other words, if we have to pay 5% on the mortgage but can earn 8% in the stock market, why not invest all of our surplus funds instead of keeping them tied up in a house.

The problem is that the 5% we will pay to the bank is guaranteed and the 8% we will make from stocks is not. Even though the interest we will pay will be tax deductible, whatever money we might make with our investment will be taxed. So in the end, it will probably be a wash. It will be much simpler and far more certain just to pay off the mortgage and get rid of the debt.

Buying a house just to rent it out and gradually build your equity position with the proceeds is a risky endeavor. Most people will find that the money they have to spend on insurance and repairs will eat up all the rent payments they receive. In a best case scenario the strategy can work—for a while—but at any time the real estate market could take a precipitous drop or the owner could be unlucky enough to rent the property to a series of unstable tenants who won’t pay regularly. Why bother with the risk and the headache when there are easier and more secure alternatives?