How Young People Can Reach Their Financial Goals

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Have a Strategy

I have seen a lot of ways people approach building investment portfolios in my 33 years. In my opinion, the three ways most people build a portfolio are: systematic purchases, valuation, and market timing. [i]

Starting Out

For most investors of relatively modest means, systematic purchases of well known, global, blue chip stocks, also known as dollar-cost-averaging, is a very good way to go. You set up a diversified portfolio that you regularly acquire over the years, staying the course during booms and busts, because you have neither the experience nor time to manage a portfolio yourself. One form of systematic purchases would be putting several hundred dollars a month into multiple direct stock purchase plans so you end up with a portfolio of blue chip companies with potential dividend income.

As to which companies to buy, I have a preference for higher quality companies that have certain advantages protecting them from competition and technological changes while simultaneously causing them to generate lots of free cash flow relative to tangible invested capital.

Adopt a "Real Estate" Mindset

Much like a successful owner of real estate, I am looking for good properties in good locations with good tenants. In stock terms, think of "blue chip" companies with global brands run by management teams with a history of increasing earnings with modest capital expenditures required. In other words, I think of myself as being in the business of acquiring risk-adjusted cash flows.

Of all the ways to reach your financial goals, systematic investing is one of the least risky if, and this is a big if, an investor is willing and able to hold onto their companies for twenty-five years.[ii] However, one must be willing to hold on, even if we go into a full-blown Great Depression tomorrow and the losses look horrific.

Timing Investments

Benjamin Graham, the father of investing, observed that most investors, under most circumstances, shouldn't worry about trying to get the best price.[iii] History has proven he was right, especially for truly excellent businesses, if you stretch the ownership period out long enough. Even the "Nifty 50"[iv], a group of companies, which traded at extremely high valuations in the 1960s (akin to the price-to-earnings ratio of 175 that Amazon sells for today), ended up beating the S&P 500 a quarter-century later despite several bankruptcies of components along the way.

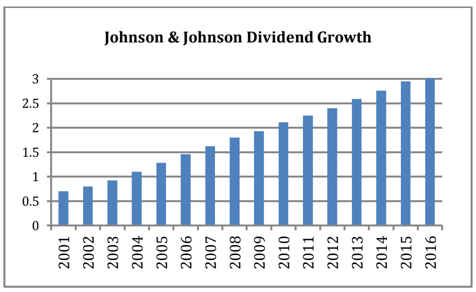

Exhibit 1[v]

Even with an occasional failure, the success of the survivors more than made up for it. One might make the argument that, as long as you're not dealing with a greater than 2% to 5% portfolio weighting, and you truly will hold for 25 years, even if we go into a 1929-1933 catastrophe, there may rarely be a bad time to buy certain blue chip companies.

The Permanent Collection

As I've gotten older, there are times I'll buy an excellent business at fair value simply to add it to my "permanent collection." In a very real way, I think of myself as a collector. I collect cash flow. Sometimes, I pick up a bit of ownership even if it isn't necessarily the highest returning asset on my desk at the moment.

Expect and Embrace Volatility

For those with a long time horizon, especially younger people, look forward to the next time the broad stock market goes down in price by 20-25%. This is your golden chance to buy more of your favorite cash machines at lower prices. Too often the media scares people into a panic and some sell at the lower prices. Remember this: stocks markets go up and down 15-20% virtually every year.[vi]

When it comes to individual companies, most of your holdings could increase or decrease peak-to-trough by at least 33% every 36 months. That's *normal*.[vii] If you buy a great business as part of a diversified portfolio, and you paid a fair price for it, it shouldn't cause concern if you wake up to find it quoted down 33%. If anyone tells you this is outside the realm of possibility, realize that you're dealing with someone who is out of their depth.

Why Being Patient Matters

It is difficult to emphasize the importance of passivity enough. Look at the length of time the assets that made Warren Buffett rich were held in the portfolio of Berkshire Hathaway. Most of the real money came from investments made more than a quarter-of-a-century ago. These stakes have generated billions upon billions in after-tax dividends that funded other, newer investments. Some of their holding periods are now surpassing the 50-year mark.[viii]

Should I Buy More On Dips?

A small percentage of investors take a hybrid approach between systematic purchases and valuation - so it's not an all-or-nothing deal. For example, investors who ran down to the HR department during the 2008-2009 collapse, and increased the amount they were putting into their 401(k) because they felt the stock market had fallen to a level that made it objectively cheap, were making a valuation determination. They de facto ended up accelerating their own recovery time by buying more shares at lower prices. The net effect reduced the average cost of their portfolio a lot faster than otherwise would have been the case.

Does it Ever Make Sense to Sell?

Of course. If you need the money, have cash on hand well before you need it. From an investment perspective, yes, at times stocks can become so highly valued it may make sense to sell. Even Buffett admitted at his 2005 shareholder meeting it had been a mistake not to sell Coca-Cola when it was at 50x earnings[ix]. So the answer for high quality companies at really high valuations is, occasionally you should sell, but not often.

What About Selling Everything?

Very rarely, if ever: maybe once or twice in each lifetime and even then, probably not everything. It is exceedingly hard to know when to sell and when to buy back in. One example was a period during the dot-com boom when Vanguard's founder, John Bogle, liquidated something like all but the last 35% of his stock and equity index fund investments, putting it, instead, in cash, Treasury securities, and bonds. The valuation gap had become so large, he talked about it being a once-in-a-generation disconnect that he could no longer ignore, he threw the "stay the course" mantra of systematic investing out the window. He felt there was no way stocks could live up to the promises that were baked into their valuations. He was right.[x]

Market Timing Explained

In contrast to objective valuation assessment is market timing. A market timer decides to buy or sell because he thinks the asset will increase or decrease in price for any myriad of reasons, none of which is necessarily tied to intrinsic value.

Even when someone pulls it off successfully for a while, the type of people attracted to the strategy usually don't benefit from it long-term because of their own shortcomings; (e.g., there is a well-known speculative market timing fund that rose more than 18% annually over a decade while the stock market as a whole did far worse[xi]. Despite this stellar performance the typical investor in the fund didn't earn the positive 18% per annum return, rather, they earned a *negative* 11% return per annum. When the fund went up, they bought more because it had increased. When the fund went down, they sold shares because it had decreased.)[xii]

Plan, Don't React

To an investor, the market price is there to be exploited or ignored. As Benjamin Graham put it in his 1949 edition of *The Intelligent Investor*:

> "The most realistic distinction between the investor and the speculator is found in their attitude toward stock market movements. The speculator's primary interest lies in anticipating and profiting from market fluctuations. The investor's primary interest lies in acquiring and holding suitable securities at suitable prices."

Passive Investing for Wealth Accumulation

In my opinion, passivity is much more effective than timing and trading when it comes to accumulating wealth. You only have to make two correct decisions – which asset to acquire and the price you want to pay. Then you sit back and enjoy the fruits it produces decade after decade. Trying to predict what any firm's stock price will do in the short-term (a.k.a. market timing) cannot be done consistently.

Do I Have to Hold for 25 Years?

Even including the Great Depression of 1929 through 1937, if you were able to hold on to your stocks, you broke even and then made money. For those few who were able to reinvest their dividends through the Great Depression, their break-even was less than five years because they bought so many more shares at such low prices. To answer the question of holding for 25 years: *under most economic scenarios, a 25-year holding period should be highly satisfactory for the prices you are likely to pay.*

What about Other Investments?

The same principle applies. If you bought a rental duplex in the suburbs of St. Louis for $300,000 that was pumping out $30,000 a year in net rents, then the next day someone showed up and offered you $210,000, is it going to cause you any distress? Are you going to be upset or think about it too much? No! You're measuring your results by the underlying cash being produced by the asset. You'd thank them for the interest but say you're not interested in parting with it.

In Conclusion

Regardless of what you invest in, it comes down to 1.) Buy really good assets, 2.) Pay fair prices relative to conservatively estimated value, 3.) Arrange your overall portfolio so the risks are tolerable, and 4.) Sit tight, avoiding the temptation to "do something". All of this has been said before so it shouldn't be news. The problem is getting people to actually do it.

Be among the few.

Is this <u>all</u> there is?

These findings apply to most situations, but not to all. A body of knowledge has been gathered through thousands of interactions with sophisticated accomplished professionals. Further detail is reserved for clients.

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