

Chapter Two

Goals for Your Financial Return

It is very difficult to achieve what you want without having a well-defined goal. Expectations are important. Certainly with something as important as personal finances, one should define their goals and outline precisely how they plan to achieve them. I will start by defining reasonable investment goals. The rest of the book will detail how to achieve these goals.

This chapter has three sections. The first outlines an average return that can be anticipated from investments. The second section details returns that are attainable, but only with hard work and common sense. The last section describes returns that are unrealistic, and when promised, should immediately cause concern and alarm. The latter is especially important because it will allow you to quickly recognize the army of promoters and sometimes just plain crooks whose only desire is to separate you from your hard-earned money.

YOUR MINIMUM INVESTMENT GOAL

Over the long term, investors should anticipate a ten percent annual return on stock market investments. Some years this will be greater, some years less, and some years there will even be losses. But over the course of your investing lifetime, actually, your investing lifetime is your entire lifetime, your goal should be a ten percent annual return on non-cash investments.

Note I emphasize non-cash. There must always be sufficient cash to cover unexpected needs, debt service, and to take advantage of opportunities. It is the person with cash who can scoop up assets when they are cheap. But the price (the risk) of cash is that its long-term return is inferior to other investments, such as stocks or real estate. But in general, it is preferable to have a little more rather than not quite enough cash.

Ten percent is a round number but was not chosen at random. Over the course of the twentieth century, stocks in the United States returned an average of just under ten percent annually. Slightly more than half of the return, almost five percent, was due to capital appreciation, a number essentially equal to the growth of corporate profits over this time period.

Slightly less than half of this return, approximately four and one-half percent, was from the payout of dividends. But when inflation is factored out, decreasing the contribution of capital appreciation, the average annual return from stocks was approximately seven percent. Thus dividends represented almost two-thirds (62% to be exact) of the wealth created by corporations in the United States in the last century. I do not know how any other statistic can better emphasize the importance of dividends.

During the stock market bubble of the late 90s, it was thought that capital appreciation was all-important and dividends were of no consequence, sought only by old fogies who remembered the Great Depression. There was a new game in town, we were operating under new rules, a “new paradigm”, old rules no longer applied. In the end, old rules always apply, that is why they are old rules. The old rule is that dividends are very important and they count a great deal. More information on dividend-oriented stocks can be found at the websites www.dividendinvestor.com and www.dividenddetective.com.

Why are dividends so important? Only by re-investing dividends can you realize “The Magnificence of Compound Interest” (see the next Chapter). Dividends are also cash in your pocket, to do with as you see fit. Cash from dividends can pay utility bills, the mortgage, your children’s education bills and

all the other expenses of daily living. Dividends are also important because investors believe that the payment of cash dividends is a reflection of a company's financial health. Investors treat a cut in the dividend as negative news about a company's future prospects, such that management will commit to increase dividends only when they are truly confident about their ability to maintain those dividends in the future. Financial analysts call this the "signaling theory of dividends." Simply stated, dividends are a signal about the future prospects for the company. Stable, and especially increasing dividends, are a general indicator of the financial health of a company.

Eventually a company must pay a dividend. If the price of a company's stock increases, but they do not pay a dividend, the only way to recognize this increase in value is to sell the stock. If the company continues not to pay a dividend, the only way the buyer can have cash to pay their daily bills is to sell the stock to someone else, and so on. Early in a company's history, their rapid growth phase, they may retain earnings for expansion, but at some time a dividend must be paid.

Stock prices may fluctuate markedly because of a change in the price to earnings (P/E) ratio. Investors are willing to pay more, or less, for what they anticipate will be a stock's earnings in the future. In the short term variations in P/E ratio are mostly expectations-driven and show a relatively poor correlation with an increase or decrease in corporate earnings. But over the long term, this variation in price to earnings ratio essentially disappears. In the end, what is left is the true value of the company – as represented by improved earnings – and the dividends that have been paid.

The minimum goal on your stock market investments is to capture the wealth created by corporate America (and increasingly, foreign economies), which in the twentieth century was an average compounded return of 10%. Considering the average physician's income, all that is required to live comfortably and retire when you wish is a little fiscal discipline and the avoidance of stupid mistakes, which is one of the principle points of this book. Financial security is important.

A REASONABLE INVESTMENT GOAL

With some work (actually with some hard work), common sense, and knowledge of where mistakes can arise, a fifteen percent compounded annual return on investments may be realized.

I choose fifteen percent for two reasons. The first is that it is attainable, you can do it. The second reason is that money will double in five years, due to the assistance of your greatest investment friend – compound interest.

Note this:

Year One $\$100 \times 15\% = \115

Year Two $\$115 \times 15\% = \132

Year Three $\$132 \times 15\% = \152

Year Four $\$152 \times 15\% = \174

Year Five $\$174 \times 15\% = \201

A little work, compound interest and patience can result in financial security.

A simple way to determine how quickly money doubles is the rule of 72. Divide the rate of return into 72. Money growing at 10% per year doubles in 7.2 years. In the example above, money growing at 15% per year doubles in just under 5 years.

Before concluding this section, I must emphasize that investing is a three-step process.

1. Earn money
2. Do not spend all of the money (for some people this is problematic)
3. Invest the money

For example, one physician saves \$10,000 and hits an investment grand slam, realizing a 25% return, resulting in \$12,500 at the end of the year. You are more thrifty, save \$15,000, and realize the standard 10% return. At the end of the year this is \$16,500. It is virtually impossible for great investing to overcome poor saving habits. The easiest way to accumulate wealth and attain financial security is save money on a regular basis and invest it wisely. Savings equals investment. **The best investors are the best savers.**

AN UNREASONABLE INVESTMENT GOAL

There are some truly gifted investments geniuses, such as Warren Buffett, George Soros and a handful of others, who have been able to generate returns of greater than 20% for prolonged periods of time, but they are literally one in a million. Of importance as it relates to this discussion is that such people will have bona-fide, verifiable results with reputations and references to match. If you should be lucky enough to find one of these truly gifted legitimate investment wizards, just hitch your star to theirs and hang on for the ride.

The point of this section is to think of a 20% return as an almost magical number in the investment world. If anyone comes to you saying they will make, almost guarantee, a twenty five percent, thirty percent or more annual return on an investment, but they do not have a track record to prove it, just tell them to forget it. It is as pure and simple as that. They could conceivably be the next Buffett or Soros (possible, but literally one in a million), but more likely they are bogus and just wish to relieve you of your money.

Here is the essence of what I feel is one of the difficulties that physicians experience with investing, and which I will detail in the remainder of this book. Physicians do not wish to be left out. They feel their great intellectual gifts, qualities that can result in being the greatest neurosurgeon, cardiologist or oncologist in the world, automatically apply to areas outside of medicine. The ability to save a life does not necessarily imply the same ability to evaluate a real estate investment or read a financial statement or determine the potential of a natural gas property in Wyoming. It just does not.

No one was blessed with greater intellectual gifts than Sir Isaac Newton. In 1687, he published *Principia (Mathematical Principles of Natural Philosophy)* which outlined the basic laws of gravity. Newton developed the calculus (credit also goes to Gottfried Wilhelm von Leibniz for his simultaneous and independent work on the calculus) to provide the mathematical quantification of his theories. Although in later years Newton was Master of the Royal Mint, and helped implement John

Locke's revolutionary idea to fix the value of coinage [1], he lost a great deal of money on the South Sea Company, one of history's most classic investment manias. Newton said "I can calculate the motions of heavenly bodies, but not the madness of people."

Do not worry about being left out. Chances are a million to one that anyone, especially someone you do not know, or have never heard of, who has no previous verifiable results, who tells you, who assures you, who guarantees you, a twenty percent or more return on your investment, will not. Just forget them. Instruct them to leave and not to come back.

SUMMARY OF CHAPTER TWO

- Reasonable anticipated long-term return on investment 10%
- Return attainable with work and common sense 15%
- Promised, but unattainable, return that should cause alarm 30%
- Dividends are very important.
- Beware of the "new paradigm". Old rules are important.
- Investing is a three-step process. You must make money and not spend it. Only then do you have money to invest.
- The best investors are the best savers.
- Being a physician does not make you smart at everything.

REFERENCE

1. Lewis N. Gold: *The Once and Future Money*. Hoboken, NJ: John Wiley & Sons, 2007.



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