When Investing Trumps Saving: Uncommon Knowledge for the Common Good I

Saturday's With Jim

By Jim Pursley
President and CIO, Gaia Capital Management, Inc.
www.gaiacapital.com
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Key Points:

- Successful long-term investing requires dedication and faith that the plan will succeed, consistency of contribution and fortitude to see the plan through thick and thin
- Over long periods (20 years minimum) small changes in the investment return have a large effect on the final balance
- Attention to market valuations at the plan's outset will help assure plan success

Dear Friends,

We believe that the major point of long-term investing is to gain an investment rate above inflation, thereby raising our living standard. The amount we will have in the future will depend on how much we save (our savings rate), the return of our investments (investment return) and the amount of time our investment has to grow before we begin "harvesting." Today's post is the first in a series which discusses how the interplay of savings rate, investment return and investment time horizon should be considered as we set out to invest. Today and next week, we will examine how the three factors work in a long-term (35 year) program. Afterwards, we will consider how they combine in a shorter program (15 years). In our final installment, we will look at key drivers of a successful retirement income program.

In the following table, we show the effect of a $100 and $200 monthly savings deposit with 7% and 9.8% investment rates of return over 35 years, which is a typical retirement savings time frame as well as the retirement income "harvesting" period for a long-lived retiree.

$100 and $200 a month invested at 7% and 9.8% for 35 years		
Monthly Contribution	Annual Rate Of Return	
	7%	9.80%
$100	$181,000	$364,000
$200	$362,000	$729,000

Investment Return Trumps Savings Rate

In the table above, doubling the savings rate from $100 a month to $200 a month doubles the amount we have after 35 years. In fact, increasing or decreasing our savings rate by x dollars has the same effect on our final balance – raising or lowering it by x dollars. But look what happens when we increase our investment return by 40% ((9.8/7)-1). Our balance doubles. Simply put, a modest increase in investment return gives an outsized (2.5 times as much) benefit in our account balance.

Practical Considerations

In the above example, 9.8% is the very long-term (since 1926) investment return of U.S. stocks and 7% is the long-term return of a 50/50 mix of stocks and quality bonds. The table above suggests that accepting the volatility of the stock market over a long period of time pays off in spades at harvest time. This said, who has an investment program of almost 100 years?

The period 1926-2013 was full of market ups and downs severe enough to cause an investor with but the toughest of skin to throw in the towel. Even if we were to hold on for our entire long-term investing period, we still might fall short of our goal. Suppose we were to start our investing in 1929 or 2000, after stocks had been bid to nosebleed levels. We might have bailed out in disgust near the lows of 1933 and 2002. Investing near the market's peak in 2007 may have caused us to terminate our programs in 2009 after a gut-wrenching loss. How can we stack the odds in our favor to succeed over the long run?

Next week, we will share our thoughts on improving the odds of success beyond merely buying, contributing and holding.

Thank you for investing with us.