Common Themes

The Wealthy Barber Returns

Significantly Older and Marginally Wiser, Dave Chilton Offers His Unique Perspectives on the World of Money

David Chilton

More than 2 million copies of *The Wealthy Barber* sold in Canada

Common Themes

I HAVE TO ADMIT THAT THIS PART of the book is a little different. In fact, I'm not even sure exactly how to describe it.

It's kind of all over the map. Actually, not "kind of" — it *is* all over the map. Some big-picture stuff, some minutiae. Some conventional wisdom, some offbeat perspectives. Some numbers, some psychology. Some fluff, some depth. Some dos, some don'ts.

I guess it's really a collection of a few of my opinions and observations on the world of personal finance. Certainly not all of them will apply to any one reader, but I'm hopeful that you'll find the vast majority interesting and that together they'll help you think more wisely about your money.

Despite the word "random" in this section's title, there are a couple of common themes running through many of the pieces that follow.

The first is that sound financial planning is surprisingly straightforward — nothing more than a combination of common sense, vanilla products and time-tested principles. Honest!

You don't have to spend hours researching on the Internet every night. (I do, but that's for my hockey pool.)

You don't have to possess great math skills. Heck, last week I asked one of the most successful investors I know what 7^3 is.

He's still working on it. On the other hand, Isaac Newton was notoriously bad with his money.

You don't have to master the strange jargon of the financial world. Yes, it's important to know some basic terms but beyond those, there's no correlation between an individual's vocabulary and his or her money-management abilities. Years ago, I congratulated a fellow on his astute retirement plan. His response? "Yeah, my RSVP is rockin'!" Hey, party on, bro.

I will admit that there are a lot of complex products in the financial arena. Many involve hours of reading and sometimes even advanced calculus to fully understand. Others are based on arcane associations of assumptions, algorithms and acronyms.

They don't work. Avoid them.

Leonardo da Vinci once stated, "Simplicity is the ultimate sophistication." Smart guy — I'm surprised he didn't accomplish more.

The second recurring theme is that human nature matters. Big time. It influences us in a variety of ways as we manage our money — few of them positive. For example, to work its wonders, a financial plan requires us to be disciplined and patient. That's a big problem because most of us, well, aren't. We're easily both distracted and scared.

We need to account for our emotional weaknesses, and to whatever extent possible, protect against them. Yet frequently, financial advice assumes we'll always behave in a completely rational manner. We won't.

Keep it simple and get out of your own way.

Common themes that need to become common practice.

A Cool Rule

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A Cool Rule

I WAS FIRST EXPOSED TO "THE RULE OF 72" in my second year of university. This will make me sound very geeky (again), but it was love at first sight.

The rule simply states:

$$\text{The years to double your money} = \text{72/rate of return compounded annually}$$

So, if you grow your money at 8 percent compounded annually, it will take you 9 years to double your money (72/8).

At 12 percent it would take you only 6 years (72/12).

At 6 percent it would take you 12 years (72/6).

At 72 percent it would take you 1 year. Whoops — that's not right. Obviously, you'd need a 100 percent return to double your money in 1 year.

Hmm. Maybe "The Rule of 72" would be more appropriately called "The Guideline of 72 That Doesn't Work Well For Extreme Rates of Return."

Regardless, the rule does provide a good approximation of doubling time for rates from 2 to 18 percent. Apply it to higher returns and it starts getting a bit wacky. But, hey, if you're consistently compounding your money at more than 18 percent a year, I should be reading your book, not the other way around.

On the low side, I'm not sure if it works for 1 percent or not. I have a broken calculator and I don't feel like figuring out on paper what 1.01^{71} is, especially with *Modern Family* starting in 10 minutes. The general rule, though, is that if you're growing your money at only 1 percent a year, it will double-over about 20 years after you do.

There are a couple of good lessons that flow from playing around with this rather cool rule.

My parents have owned their home for almost 48 years. They bought it for $19,800 and it's now worth about $320,000. Seems pretty impressive. But what's "The Rule of 72" say? Well, the house value doubled from 20 grand to 40, then 40 to 80, then 80 to 160 and, finally, from 160 to 320. That's 4 doubles in 48 years or 1 every 12 years. That's a compounded rate of return of 6 percent a year.

My mom and dad were surprised that their return *only* averaged 6 percent. It seemed like a lot more growth. But 48 years is a long time for compounding to work its magic.

Some folks aren't just surprised when I perform this type of calculation for them, they're also borderline annoyed. They insist their investment returns must be higher than our mathematical shortcut indicates. Who are these bold deniers who have the audacity to challenge my beloved "Rule of 72"?

Cottage owners, usually.

For example, a few years ago, an elderly couple explained to me that their cottage, purchased for $50,000, was now worth $200,000. "An incredible investment that can't be matched by anything else. Don't you agree?" the husband challenged me.

"Well, it depends on how long you've owned it," I cautioned.

"Forty glorious years!" the wife responded.

"That works out to about 3.6 percent a year," I calculated using my trusty rule. (They averaged a double every 20 years and 72/20 equals 3.6.) "Plus," I added, "you have to account for all your ongoing expenses, such as property taxes, utilities and maintenance. And did you ever spend money renovating?"

From the looks on their faces, you'd think I had just poked them with a sharp stick. This reinforced something that, through many similar experiences, I should have long since internalized: Never ever try to rationally discuss the math of cottage ownership with cottage owners. Never. Ever.

The bigger lesson, though, evidenced by applying "The Rule of 72," is that seemingly small differences in rates of return can make a huge difference in the wealth created over time.

Hard-to-believe huge.

Impossible-to-overstate-the-importance-of huge.

Let's say you were starting out with $10,000 in your registered retirement savings plan (RRSP). You invest the money without learning the basics or developing a plan. Over the years, you pay little attention to costs and on several occasions let your emotions get the best of you. In short, you act like most of us. You go on to average a 4 percent rate of return compounded annually.

Your best friend, who invests $10,000 at the same time, manages to mix together common sense and discipline and averages an 8 percent return compounded annually.

"Whatever," you think. "So he ends up with a little more money. Good for him, he's a great guy. No biggie."

Actually, you'd be right if you were talking about a one-year time period. You'd end up with $10,400; he'd have $10,800. What's $400 between friends? He would probably take you and your spouse out for dinner.

Ah, but what if the money was left alone for 18 years? You'd have $20,000 because at 4 percent, money doubles every 18 years.

He'd have $40,000! Yep, at 8 percent, money doubles every 9 years — 2 doubles and, presto, 10 is 40.

How can that be? You both worked equally hard and made the same sacrifices to save the original $10,000. You practiced the impressive restraint that he did and avoided the temptation to raid your RRSP. Sure, you could have invested more wisely, but it's not like buddy boy was posting spectacular double-digit returns.

It's not fair.

And it gets worse.

Thirty-six years in, nearing retirement, things have turned downright ugly. Your original $10,000 is now $40,000 (10 x 2 x 2). His is now $160,000 (10 x 2 x 2 x 2 x 2).

You're dog-sitting for him while he and his wife travel through the vineyards of Northern Italy for the second time in six months. "We just had to see them in the fall," he explains.

Your bitterness reinforces economist Charles Kindleberger's opinion: "There is nothing so disturbing to one's well-being and judgment as to see a friend get rich."

I play around with this kind of comparison frequently, yet it still blows me away that the former best friend forever (FBFF) ends up with so much more money. Even more troubling, I see similar situations in real life all the time.

Albert Einstein once declared, "The most powerful force in the universe is compound interest." Harnessing that power efficiently is what good investing is all about.

Modestly better returns make for dramatically better retirements. And "The Rule of 72" proves it.

Dashed Hopes

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Dashed Hopes

A BUDDY OF MINE, DAVE KNAPP, once asked me where race horses fit into a financial plan.

They don't.

Many years ago, I talked a number of skeptical friends into purchasing a standardbred horse. That's the breed that races in harnesses at a trot or pace.

The 18 of us parted with $2,500 each. We spent most of the $45,000 on a gorgeous American horse, Dash Lauxmont, and planned to cover ongoing expenses with the rest.

Dash broke his leg the day we bought him. Seriously.

We knew these are fragile animals. We were all fully aware of the high risk of injury. But, c'mon, the first day? You've got to be kidding.

The trainer delivered the bad news over the phone from New Jersey: "Dave, I don't know how to tell you this, but Dash was stomping his foot in the trailer and snapped his cannon bone. It's not good...not good at all."

"Well, Brad," I calmly began, "obviously, it's horrible for the horse but we're covered financially. As you advised, I insured Dash this morning as soon as we hung up the phone."

"That's not going to help. The policy won't pay unless Dash is dead."

"Shoot him," I logically suggested. "Isn't that what's done?"

"Oh, no," Brad replied. "We don't do that anymore unless the horse is in permanent pain and it would be inhumane to let him suffer. No, we'll nurse Dash back to health, but he'll probably never race again."

"Shoot me," I then begged.

I was devastated and embarrassed. And for good reason. I had picked up the investors' cheques just the day before. How could I, a mere 24 hours later, tell them that I'd already lost most of their money? No nights at the races. No daily doubles. No Little Brown Jug. Nothing.

"Don't give up quite yet," Brad consoled me. "We'll send Dash to the Kawartha Downs area. I know some trainers there who will work him out in a huge pool. Swimming — that could do the trick. It's the same motion as running but it doesn't put any stress on the fracture. Yeah, it's a long shot, but who knows?"

Even visions of Dash in a Speedo were less off-putting than the thought of calling my buddies. I gave my approval.

Well, months went by without even an update. Had Dash drowned? Did they let him in the pool within 20 minutes of eating? I couldn't take not knowing, so I called the facility's manager.

"Oh, he's a marvellous swimmer," the upbeat lady comforted me. "Beautiful to watch. Delightful. Makes friends easily...."

Basically, Dash was at summer camp having a fabulous time. Unfortunately for us, it was expensive and he didn't come from a wealthy family.

Then, a miracle.

Brad called with the incredible news: "Dash is healed — he'll be racing in six weeks!"

Was I pumped! All 18 of us were. When the big night arrived, we were out in full force. Some guys rented limos. Some wore tuxes. Some smoked fancy cigars. The evening was pure magic.

Until Dash arrived.

The handlers had trouble settling him into the starting gate. But not nearly as much trouble as our driver had getting him out of it.

Perhaps Dash didn't hear the gun. Water in his ears, I suspect. As the other horses neared the first turn, our boy was apparently still visualizing. I wondered if any horse had ever been lapped. Eventually, he sauntered from the gate and leisurely headed out. When your horse stops and waves, it's not a good sign.

Things didn't get better with time. Last, last, last, last. Race after race, Dash provided almost surreal consistency. When he finally broke through and finished second last, we were accused of doping. He didn't pace so much as he shuffled. His movement eerily resembled the moonwalk. The only good news was that at this speed there was no risk of reinjury.

Had it not been pre-smartphone days, I'm sure our driver would have been texting during the races. One night Dash was so slow he actually got in the winner's circle photo. Great keepsake.

Much like the movie *Free Willy*, we dreamt of returning Dash to his natural habitat — the water. But tragically, we had run out of money.

What to do? We convened a meeting where I suggested giving Dash to a local farmer. One of the partners objected, "I don't want to give him away; I want to race him."

"Go ahead, you'll probably beat him," another snickered.

Eventually, Dash ended up in Detroit. Perhaps he worked the birthday-party circuit. Believe me, no children would have been in danger.

Showman Billy Rose once advised, "Never invest your money in anything that eats...."

Words to live by.

A Misunderstood Shortcut

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RBC

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A Misunderstood Shortcut

WOW, I COULDN'T BELIEVE HOW annoyed some readers were because I didn't include an index in *The Wealthy Barber*. Especially librarians. One from California wrote, "No index? You, sir, should be shot!" And that was from a left-leaning state; I shudder to think what the Texans wanted to do to me.

So it's a bit ironic that I'm now going to discuss what an index is. But, of course, the kind of index I'm talking about here has nothing to do with the pages at the back of a book. No, what we're looking at in this chapter is the type of index used in the statistical world: A single number that summarizes a collection of data and often serves as a benchmark for comparison.

Sounds complicated. Isn't.

Yet very few people truly grasp this concept. In fact, I recently asked a group of financial types what an index is and got more than a few crazy answers, including "a finger."

Think of an index as an aid. A shortcut. A time saver.

All totals are indices (or indexes). So are all averages. And all medians.

A golf handicap is an index. The inflation rate is an index. Mrs. Landers' class average is an index. Your career-earnings total is an index.

Anybody can make up an index. I could take my 20 closest friends, total the number of books they read in a year, figure out the average and call that figure the CFBI (Chilton Friend Book Index). It would not be an impressive figure, I assure you.

Hey, you could calculate the equivalent index for your friends and we could compare. Or I could track the CFBI year after year and see if my friends are becoming better read. How likely would that be? Never mind.

The financial world creates and uses indices all the time. Thank goodness. Without them, it would be impossible to effectively communicate and compare the industry's overwhelming volume of data.

For example, one of the most common questions — "How did the stock market do today?" — would be virtually impossible to answer. There are thousands of publicly traded companies, and reciting all of their closing prices would be quite a chore.

Ah, but with an index, the response is as simple as, "The S&P/TSX Composite was up 1.1 percent."

Easy-peasy, as my not-so-eloquent daughter would say.

The S&P/TSX Composite is the Canadian equity markets' best-known index. It's one figure, a weighted average, that summarizes lots of data — the share prices of about 250 of Canada's largest public companies.

There are a number of ways companies can be weighted in an index. They can all be given equal weightings and, on occasion, you'll see that. It seems odd, though, that a two percent move in the price of a relatively small company would have the same effect on an index's value as a two percent move in the price of the biggest. But whoever designs the index sets the rules.

Most equity indices are "cap-weighted." Nothing tricky here. Cap is short for market capitalization, which is calculated by simply multiplying the number of shares a company has outstanding by its market price per share. If company X is worth three times as much as company Y, X receives three times the weighting in determining the index.

Makes good sense.

The S&P/TSX Composite is cap-weighted, as are most of the world's major indices.

An index could also weight each company based on its share price. A firm trading at $30 would carry three times the impact of one trading at $10. But what if the $10-a-share company had nine million shares outstanding and the $30-a-share company had only one million? Hmm. The smaller company would have triple the weighting of the bigger company, despite having only one-third of its market capitalization.

Clearly, weighting by share price is a goofy idea. Curiously, though, that's how one of the world's most famous indices, the Dow Jones Industrial Average, is structured.

Weird.

There are indices for bonds, commodities and real estate, too. Plus, there's an index for a seemingly endless number of subsets of each of the asset classes. From emerging-market stocks to big-dividend payers to corporate bonds to agricultural commodities — there's an index (or several) out there.

But it's key to note again that all of them have two things in common: (1) They are single numbers that summarize a collection of data; (2) Somebody, or somebodies, made them up. He/she/they chose the contributing components, decided on the weighting approach and set the rules.

Frequently, I'll hear, "I want to buy such and such an index." Not possible. Remember, it's just a number — an abstract concept. What you can do is buy the components of an index in their prescribed weightings. Doing this on your own is a major hassle, but there are mutual funds (not shockingly called "index funds") and exchange-traded funds (ETFs) that will do it for you inexpensively.

The financial industry often terms index-fund investors "passive" and all others "active." I've never been comfortable with those labels. There are many Canadians who buy and hold several companies' shares indefinitely. These investors almost never trade — they are truly passive, yet they're branded active. And nowadays we have many other Canadians who jump in and out of index funds and ETFs trying to time the markets or play the hot sector. They're not passive — they're *hyper*active. They're not just sitting back, they're making things happen. Things like commissions, higher taxes and below-average returns, for example.

You've probably noticed that this chapter has been a little different. There haven't been any deep insights or unique perspectives. (OK, so it hasn't been *that* different.) But understanding what an index is makes following the financial markets more interesting and more fun.

Plus, now you can sound in the know at a party by opining: "I think it's ridiculous that the Dow is a price-weighted index; cap-weighting makes so much more sense."

Then again your conversation partner may respond, "Good point. I've been looking at the MSCI EAFE but I'm also drawn to fundamental indices and inverse ETFs."

On second thought, it's probably best to keep this to yourself.

A Widely Held Misconception

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A Widely Held Misconception

MEDIA TYPES SEEM TO SAVOUR this line: "Billions of dollars have left the stock market over the last several weeks."

After these news reports, people invariably ask me, "Where do you think all the money is going? Bonds? Gold? Real estate?"

None of the above.

Let's say there are one million shares of Chilton Incorporated outstanding. They last traded yesterday at $10 a share, giving the company a market value of $10 million.

Realizing that no company named after me could truly be worth that much, you wisely decide to sell your 1,000 shares. Unfortunately, it's a rough day for equities and there are no buyers at $10 a share. You're so eager to move on that you happily accept the best offer at $9.

Chilton Inc.'s market value is suddenly only $9 million.

By selling a mere $9,000 worth of stock, you've lopped $1 million off the company's market value. You've ruined the fun for all of us.

Stock prices are set not by the entire market through careful analysis and consensus building, but by the decisions of the very small percentage of owners currently looking to sell and the very small percentage of potential investors currently looking to buy.

It takes surprisingly few people — many acting on emotions instead of rational thought — to dramatically affect prices in the short run. That helps explain why stocks are so volatile. It's also a good reason to pay little attention to day-to-day price fluctuations. They're noise. As Warren Buffett's mentor, Benjamin Graham, so cleverly put it: "In the short run, the market is a voting machine, but in the long run it is a weighing machine."

It's important to understand a million bucks didn't leave the market in this transaction; only $9,000 did. And even that's misleading because $9,000 also came in from the buyer — an obvious, yet often neglected, point.

No "net" money departed the market.

So where did the million dollars in lost market value go?

Poof.

