Rich Man, Poor Man
The Power of Compounding
Rule 2: Don't Lose Money
Memphis, Montreal, Orlando, Las Vegas, New York, La Jolla

By John Mauldin

It is Good Friday, and I am going to take the writing day off. Next week we will delve further into the rich mines we began to explore last week on complexity theory and fingers of instability. But I am going to give you something better than my poor missives. Today we look at the chapter by Richard Russell from my book *Just One Thing*. To find out more about the book, you can click on the book cover nearby or go to www.amazon.com/justonething .

What can one say about my friend Richard Russell without using a lot of superlatives? Richard has been writing and publishing the *Dow Theory Letters* since 1958, and never has he missed an issue! It is the longest newsletter service continuously published by one person in the investment business. Richard is now 80 years old, and writes an extremely popular daily e-letter, full of commentary on the markets and whatever interests him that day. He gets up at 3 am or so and starts his daily (massive) reading and finishes the letter just after the markets close. He is my business hero.

He was the first writer to recommend gold stocks in 1960. He called the top of the 1949-66 bull market, and called the bottom of the bear market in 1974 almost to the day, predicting a new bull market. (Think how tough it was to call for a bull market in late 1974, when things looked really miserable!) He was a bombardier in WWII, lived through the Depression, wars, and bull and bear markets. I would say that Russell is one of those true innate market geniuses that have simply forgotten more than most of us will ever know, except I am not certain he has forgotten anything. His daily letter is loaded with references and wisdom from the past and gives us a guide to the future. (You can learn more – and subscribe! – at www.dowtheoryletters.com .)

When I asked Richard to contribute an article, I wanted his wisdom more than his actual market theory, and that is what he has given us. You (and your kids!) should read this again and again! Richard lives in La Jolla with his wife Faye.

Rich Man, Poor Man

By Richard Russell

Making money entails a lot more than predicting which way the stock or bond markets are heading or trying to figure which stock or fund will double over the next few years. For the great majority of investors, making money requires a plan, self-discipline, and desire. I say "for the great majority of people," because if you're a Steven Spielberg or a Bill Gates you don't have to know about the Dow or the markets or about yields or price/earnings ratios. You're a phenomenon in your own field, and you're going to make big money as a by-product of your talent and ability. But this kind of genius is rare.

For the average investor, you and me, we're not geniuses so we have to have a financial plan. In view of this, I offer below a few rules and a few thoughts on investing that we must be aware of if we are serious about making money.

I. **The Power of Compounding**

Rule 1: Compounding. One of the most important lessons for living in the modern world is that to survive you've got to have money. But to live (survive) happily, you must have love, health (mental and physical), freedom, intellectual stimulation — and money. When I taught my kids about money, the first thing I taught them was the use of the "money bible." What's the money bible? Simple, it's a volume of the *compounding interest tables.*

Compounding is the royal road to riches. Compounding is the safe road, the sure road, and fortunately anybody can do it. To compound successfully you need the following: perseverance in order to keep you firmly on the savings path. You need intelligence in order to understand what you are doing and why. You need knowledge of the mathematical tables in order to comprehend the amazing rewards that will come to you if you faithfully follow the compounding road. And, of course, you need time, time to allow the power of compounding to work for you. Remember, compounding *only works through time.*

But there are two catches in the compounding process. The first is obvious — compounding may involve sacrifice (you can't spend it and still save it). Second, compounding is boring — b-o-r-i-n-g. Or I should say it's boring until (after seven or eight years) the money starts to pour in. Then, believe me, compounding becomes very interesting. In fact, it becomes downright fascinating!

In order to emphasize the power of compounding, I am including the following extraordinary study, courtesy of Market Logic, of Ft. Lauderdale, FL 33306.

In this study we assume that investor B opens an IRA at age 19. For seven consecutive periods he puts $2,000 into his IRA at an average growth rate of 10% (7% interest plus growth). After seven years this fellow makes NO MORE contributions — he's finished.

A second investor, A, makes no contributions until age 26 (this is the age when investor B was finished with his contributions). Then A continues faithfully to contribute $2,000 every year until he's 65 (at the same theoretical 10% rate).

Now study the incredible results. B, who made his contributions earlier and who made only seven contributions, ends up with MORE money than A, who made 40 contributions but at a LATER TIME. The difference in the two is that B had *seven more early years of* *compounding than A.* Those seven early years were worth more than all of A's 33 additional contributions.

This is a study that I suggest you show to your kids. It's a study I've lived by, and I can tell you, “It works.” You can work your compounding with muni-bonds, with a good money market fund, with T-bills, or say with five-year T-notes.

	INVESTOR A		INVESTOR B	
Age	Contri-bution	Year-End Value	Contri-bution	Year-End Value
8	-0-	-0-	-0-	-0-
9	-0-	-0-	-0-	-0-
10	-0-	-0-	-0-	-0-
11	-0-	-0-	-0-	-0-
12	-0-	-0-	-0-	-0-
13	-0-	-0-	-0-	-0-
14	-0-	-0-	-0-	-0-
15	-0-	-0-	-0-	-0-
16	-0-	-0-	-0-	-0-
17	-0-	-0-	-0-	-0-
18	-0-	-0-	-0-	-0-
19	-0-	-0-	2,000	2,200
20	-0-	-0-	2,000	4,620
21	-0-	-0-	2,000	7,282
22	-0-	-0-	2,000	10,210
23	-0-	-0-	2,000	13,431
24	-0-	-0-	2,000	16,974
25	-0-	-0-	2,000	20,872
26	2,000	2,200	-0-	22,959
27	2,000	4,620	-0-	25,255
28	2,000	7,282	-0-	27,780
29	2,000	10,210	-0-	30,558
30	2,000	13,431	-0-	33,614
31	2,000	16,974	-0-	36,976
32	2,000	20,872	-0-	40,673
33	2,000	25,159	-0-	44,741
34	2,000	29,875	-0-	49,215
35	2,000	35,062	-0-	54,136
36	2,000	40,769	-0-	59,550
37	2,000	47,045	-0-	65,505
38	2,000	53,950	-0-	72,055
39	2,000	61,545	-0-	79,261
40	2,000	69,899	-0-	87,187
41	2,000	79,089	-0-	95,905
42	2,000	89,198	-0-	105,496
43	2,000	100,318	-0-	116,045
44	2,000	112,550	-0-	127,650
45	2,000	126,005	-0-	140,415
46	2,000	140,805	-0-	154,456
47	2,000	157,086	-0-	169,902
48	2,000	174,995	-0-	186,892
49	2,000	194,694	-0-	205,581
50	2,000	216,364	-0-	226,140
51	2,000	240,200	-0-	248,754
52	2,000	266,420	-0-	273,629
53	2,000	295,262	-0-	300,992
54	2,000	326,988	-0-	331,091
55	2,000	361,887	-0-	364,200
56	2,000	400,276	-0-	400,620
57	2,000	442,503	-0-	440,682
58	2,000	488,953	-0-	484,750
59	2,000	540,049	-0-	533,225
60	2,000	596,254	-0-	586,548
61	2,000	658,079	-0-	645,203
62	2,000	726,087	-0-	709,723
63	2,000	800,896	-0-	780,695
64	2,000	883,185	-0-	858,765
65	2,000	973,704	-0-	944,641
Less Total Invested:		(80,000)		(14,000)
Equals Net Earnings:		893,704		930,641
Money Grew:		11-fold		66-fold

Rule 2: Don't Lose Money. This may sound naive, but believe me it isn't. If you want to be wealthy, you must not lose money; or I should say, you must not lose BIG money. Absurd rule, silly rule? Maybe, but MOST PEOPLE LOSE MONEY in disastrous

investments, gambling, rotten business deals, greed, poor timing. Yes, after almost five decades of investing and talking to investors, I can tell you that most people definitely DO lose money, lose big-time — in the stock market, in options and futures, in real estate, in bad loans, in mindless gambling, and in their own businesses.

Rule 3: Rich Man, Poor Man. In the investment world the wealthy investor has one major advantage over the little guy, the stock market amateur, and the neophyte trader. The advantage that the wealthy investor enjoys is that HE DOESN'T NEED THE MARKETS. I can't begin to tell you what a difference that makes, both in one's mental attitude and in the way one actually handles one's money.

The wealthy investor doesn't need the markets, because *he already has all the income he needs.* He has money coming in via bonds, T-bills, money-market funds, stocks, and real estate. In other words, the wealthy investor *never feels pressured* to "make money" in the market.

The wealthy investor tends to be an expert on values. When bonds are cheap and bond yields are irresistibly high, he buys bonds. When stocks are on the bargain table and stock yields are attractive, he buys stocks. When real estate is a great value, he buys real estate. When great art or fine jewelry or gold is on the "giveaway" table, he buys art or diamonds or gold. In other words, the wealthy investor puts his money where the great values are.

And if no outstanding values are available, the wealthy investors *waits.* He can afford to wait. He has money coming in daily, weekly, monthly. The wealthy investor knows what he is looking for, and he doesn't mind waiting months or even years for his next investment (they call that patience).

But what about the little guy? This fellow always feels pressured to "make money." And in return he's always pressuring the market to "do something" for him. But sadly, the market isn't interested. When the little guy isn't buying stocks offering 1% or 2% yields, he's off to Las Vegas or Atlantic City trying to beat the house at roulette. Or he's spending 20 bucks a week on lottery tickets, or he's "investing" in some crackpot scheme that his neighbor told him about (in strictest confidence, of course).

And because the little guy is trying to force the market to do something for him, he's a guaranteed loser. The little guy doesn't understand values, so he constantly overpays. He doesn't comprehend the power of compounding, and he doesn't understand money. He's never heard the adage, "He who understands interest, earns it. He who doesn't understand interest, pays it." The little guy is the typical American, and he's deeply in debt.

The little guy is in hock up to his ears. As a result, he's always sweating — sweating to make payments on his house, his refrigerator, his car, or his lawn mower. He's impatient, and he feels perpetually put upon. He tells himself that he has to make money — fast. And he dreams of those "big, juicy mega-bucks." In the end, the little guy wastes his money in the market, or he loses his money gambling, or he dribbles it away on senseless schemes. In short, this “money-nerd” spends his life dashing up the financial down escalator.

But here's the ironic part of it. If, from the beginning, the little guy had adopted a strict policy of never spending more than he made, if he had taken his extra savings and compounded it in intelligent, income-producing securities, then in due time he'd have money coming in daily, weekly, monthly, just like the rich man. The little guy would have become a financial winner, instead of a pathetic loser.

Rule 4: Values. The only time the average investor should stray outside the basic compounding system is when a given market offers outstanding value. I judge an investment to be a great value when it offers (a) safety, (b) an attractive return, and (c) a good chance of appreciating in price. At all other times, the compounding route is safer and probably a lot more profitable, at least in the long run.

II. Time

TIME: Here's something they won't tell you at your local brokerage office or in the “How to Beat the Market” books. All investing and speculation is basically an exercise in attempting to beat time.

"Russell, what are you talking about?”

Just what I said — when you try to pick the winning stock or when you try to sell out near the top of a bull market or when you try in-and-out trading, you may not realize it but what you're doing is trying to beat time.

Time is the single most valuable asset you can ever have in your investment arsenal. The problem is that none of us has enough of it.

But let's indulge in a bit of fantasy. Let's say you have 200 years to live, 200 years in which to invest. Here's what you could do. You could buy $20,000 worth of municipal bonds yielding, say, 5.5%.

At 5.5% money doubles in 13 years. So here's your plan: each time your money doubles you add another $10,000. So at the end of 13 years you have $40,000 plus the $10,000 you've added, meaning that at the end of 13 years you have $50,000.

At the end of the next 13 years you have $100,000, you add $10,000, and then you have $110,000. You reinvest it all in 5.5% munis, and at the end of the next 13 years you have $220,000 and you add $10,000, making it $230,000.

At the end of the next 13 years you have $460,000 and you add $10,000, making it $470,000.

In 200 years there are 15.3 doubles. You do the math. By the end of the 200th year you wouldn't know what to do with all your money. It would be coming out of your ears. And all with minimum risk.

So with enough time, you would be rich — guaranteed. You wouldn't have to waste any time picking the right stock or the right group or the right mutual fund. You would just compound your way to riches, using your greatest asset: time.

There's only one problem: in the real world you're not going to live 200 years. But if you start young enough or if you start your kids early, you or they might have anywhere from 30 to 60 years of time ahead of you.

Because most people have run out of time, they spend endless hours and nervous energy trying to beat time, which, by the way, is really what investing is all about. Pick a stock that advances from 3 to 100, and if you've put enough money in that stock you'll have beaten time. Or join a company that gives you a million options, and your option moves up from 3 to 25 and again you’ve beaten time.

How about this real example of beating time. John Walter joined AT&T, but after nine short months he was out of a job. The complaint was that Walter “lacked intellectual leadership.” Walter got $26 million for that little stint in a severance package. That's what you call really beating time. Of course, a few of us might have another word for it — and for AT&T.

III. Hope

HOPE: It's human nature to be optimistic. It's human nature to hope. Furthermore, hope is a component of a healthy state of mind. Hope is the opposite of negativity. Negativity in life can lead to anger, disappointment, and depression. After all, if the world is a negative place, what's the point of living in it? To be negative is to be anti-life.

Ironically, it doesn't work that way in the stock market. In the stock market hope is a hindrence, not a help. Once you take a position in a stock, you obviously want that stock to advance. But if the stock you bought is a real value, and you bought it right, you should be content to sit with that stock in the knowledge that over time its value will out without your help, without your hoping.

So in the case of this stock, you have value on your side — and all you need is patience. In the end, your patience will pay off with a higher price for your stock. Hope shouldn't play any part in this process. You don't need hope, because you bought the stock when it was a great value, and you bought it at the right time.

Any time you find yourself hoping in this business, the odds are that you are on the wrong path — or that you did something stupid that should be corrected.

Unfortunately, hope is a money-loser in the investment business. This is counterintuitive but true. Hope will keep you riding a stock that is headed down. Hope will keep you from taking a small loss and, instead, allow that small loss to develop into a large loss.

In the stock market hope gets in the way of reality, hope gets in the way of common sense. One of the first rules in investing is “don't take the big loss.” In order to do that, you've got to be willing to take a small loss.

If the stock market turns bearish, and you're staying put with your whole position, and you're HOPING that what you see is not really happening — then welcome to poverty city. In this situation, all your hoping isn't going to save you or make you a penny. In fact, in this situation hope is the devil that bids you to sit — while your portfolio of stocks goes down the drain.

In the investing business my suggestion is that you avoid hope. Forget the siren, hope; instead, embrace cold, clear reality.

IV. Acting

ACTING: A few days ago a young subscriber asked me, “Russell, you've been dealing with the markets since the late 1940s. This is a strange question, but what is the most important lesson you've learned in all that time?”

I didn't have to think too long. I told him, “The most important lesson I've learned comes from something Freud said. He said, ‘Thinking is rehearsing.’ What Freud meant was that thinking is no substitute for acting. In this world, in investing, in any field, there is no substitute for taking action.”

This brings up another story which illustrates the same theme. J.P. Morgan was “Master of the Universe” back in the 1920s. One day a young man came up to Morgan and said, “Mr. Morgan, I'm sorry to bother you, but I own some stocks that have been acting poorly, and I'm very anxious about these stocks. In fact worrying about those stocks is starting to ruin my health. Yet, I still like the stocks. It's a terrible dilemma. What do you think I should do, sir?”

Without hesitating Morgan said, “Young man, sell to the sleeping point.”

The lesson is the same. There's no substitute for acting. In the business of investing or the business of life, thinking is not going to do it for you. Thinking is just rehearsing. You must learn to act.

That's the single most important lesson that I've learned in this business.

Again, and I've written about this episode before, a very wealthy and successful investor once said to me, “Russell, do you know why stockbrokers never become rich in this business?”

I confessed that I didn't know. He explained, “They don't get rich because they never believe their own bullshit.”

Again, it's the same lesson. If you want to make money (or get rich) in a bull market, thinking and talking isn't going to do it. You've got to buy stocks. Brokers never do that. Do you know one broker who has?

A painful lesson: Back in 1991 when we had a perfect opportunity, we could have ended Saddam Hussein's career, and we could have done it with ease. But those in command, for political reasons, didn't want to face the adverse publicity of taking additional US casualties. So we stopped short, and Saddam was home free. We were afraid to act. And now we're dealing with that failure to act with another and messier war.

In my own life many of the mistakes I've made have come because I forgot or ignored the “acting lesson.” Thinking is rehearsing, and I was rehearsing instead of acting. Bad marriages, bad investments, lost opportunities, bad business decisions — all made worse because we fail for any number of reasons to act.

The reasons to act are almost always better than the reasons you can think up not to act. If you, my dear readers, can understand the meaning of what is expressed in this one sentence, then believe me, you've learned a most valuable lesson. It's a lesson that has saved my life many times. And I mean literally, it's a lesson that has saved my life.

Memphis, Montreal, Orlando, Las Vegas, New York, La Jolla

I have been enjoying the last few months of not traveling, although that is going to come to an end soon. As noted in the headline, I will be in Memphis, Montreal, Orlando, Las Vegas, New York, and La Jolla in May and June. And I am trying to keep up with my research and writing for my book project. I am really having as much fun as I have ever had on a project. I hope I can translate that enthusiasm into the book!

This is a time when we celebrate transformation and renewal. When what is wrong can be changed. When we can learn where true value really lies.. The weather is great in Texas. Seems like the time for a really long walk outside. So I think I will hit the send button and leave the office behind for a few days! Have a happy Easter. Enjoy your friends and family.

Your really enjoying life analyst,

John Mauldin