

THE 10 FUNDAMENTAL AXIOMS FOR EFFECTIVE RETIREMENT INVESTING

By Jack Griggs, William P. Dukes and J. William Petty

These principles provide the critical cornerstone for guiding investment philosophy and making decisions. When any of the axioms are violated, it is done at the risk of being derailed from the ultimate objective of accumulating a more-than-adequate fund for retirement.

There are as many disparate financial needs and circumstances as there are individuals. Ultimately, though, most individuals share, at least in part, a common goal—the creation of financial wealth for retirement.

Unfortunately, many individuals have neither the time nor the inclination for the study of investment planning. One common solution to this problem is to simply throw their hands up in despair, with the common result—a costly investment error.

However, it isn't necessary to understand the inner workings of the securities markets nor the mathematical economies underlying investment theory to make good investment choices.

In this article, we present the 10 axioms of effective investing. These principles provide the critical cornerstone for guiding investment philosophy and making decisions.

Let's take a closer look at each axiom.

Axiom 1: Start now, not later.

By investing early, you are using the greatest tool available to an investor—the power of compounding, where invested money grows exponentially, not algebraically.

The importance of starting early can best be demonstrated by an example. Consider two young investors, both age 35, and both of whom want to retire at age 70; therefore, each has a 35-year investment horizon. They both also have the goal of accumulating \$1 million by retirement. But they have devised different strategies for attaining that goal:

- Investor A will invest \$4,500 annually for the first 10 years, and then will save no more during years 11 through 35; the total investment dollars committed are \$45,000.
- Investor B will postpone any investing until after the first 10 years, but then will invest \$4,500 a year for the next 25 years; his total investment commitment is \$112,500.

Let's assume that both earn 11% annually on their savings. Table 1 shows the results. Investor A will realize his goal—by age 70, he will have \$1,022,293, even though he actually put away money for only 10 years.

Poor Investor B, however, does not reach his goal—he has only \$514,860 at age 70, even though he invested two and one-half times that of Investor A. He simply started too late.

You can see even more clearly the effect of compounding on ultimate retirement value by examining the graph in Figure 1, which shows the amount that would be accumulated by investing an initial amount of \$1,000 over a 35-year period. By reviewing the graph, you can see the exponential nature of compounding—that is, the graphed line representing the amount saved increases at an increasing rate, especially in the later years.

Jack Griggs is a professor in the accounting and finance department at Abilene Christian University in Abilene, Texas. William P. Dukes is a professor of finance at Texas Tech University in Lubbock, Texas. J. William Petty is a professor of finance in the finance, insurance & real estate department at Baylor University in Waco, Texas.

TABLE 1. EFFECTS OF STARTING SOONER RATHER THAN LATER ON AMOUNTS SAVED FOR RETIREMENT

Age	No of Years	Accumulated Savings	
		Investor A	Investor B
35	0	\$4,500	\$0
40	5	\$28,025	\$0
45	10	\$75,249	\$0
50	15	\$126,799	\$28,025
55	20	\$83,122	\$75,249
60	25	\$360,036	\$154,824
65	30	\$606,681	\$288,913
70	35	\$1,022,293	\$514,860

The basic principle: **START NOW, NOT LATER.**

Axiom 2: Set reasonable savings goals, then live below your means.

Being frugal is the cornerstone of wealth building. Those individuals who gain financial independence do so by budgeting, controlling expenses and saving a reasonable portion of their income. They value thrift and discipline. They understand that the key to being a successful investor is an attitude of conservation and stewardship. The route to financial independence is a slow accumulation of wealth versus a fantasy of get-rich-quick investing.

The key to wealth accumulation is to set reasonable savings goals and then to “pay yourself first” by setting aside that savings amount with each paycheck you receive. Each time you get a pay raise, increase your monthly savings by an amount with which you are comfortable.

The amount one saves need not be large, but if you pay yourself first each time you receive a paycheck, the magic of compounding will help you build wealth.

Axiom 3: Know what to expect based on a long history of investor experiences.

There are many places where individuals can and should invest. What rates of return should one expect?

The word “expect” is important here, because seldom do investments provide us with the exact rate of return we thought they would. Therefore, looking at

of return over long periods of time is extremely helpful in setting expectations.

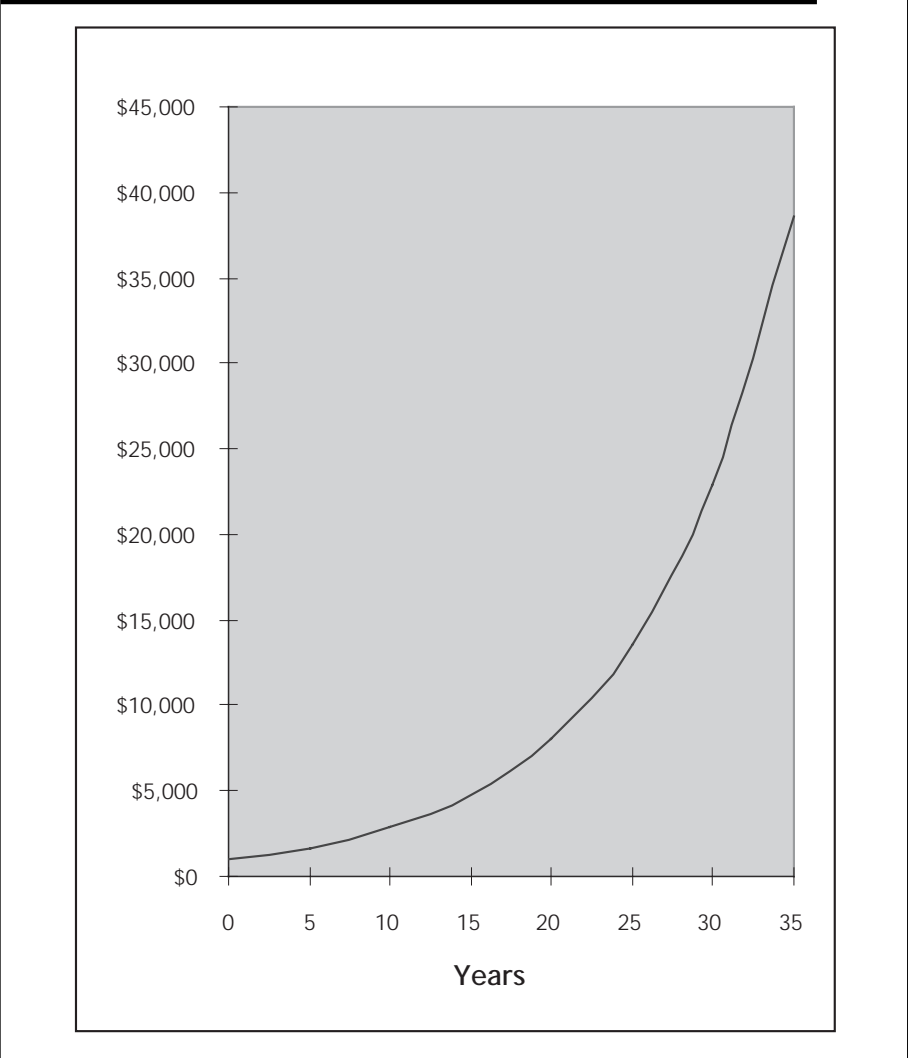
Table 2 reports the rates of return, as well as how much \$1 would have

grown to, for four different types of investments, as well as the inflation rate, from 1926 through 2002:

- Short-term U.S. debt (Treasury bills),
- Long-term U.S. government bonds,
- Stock issued by the largest 500 U.S. companies (Standard & Poor’s 500), and
- Stock issued by smaller companies that are publicly traded.

You can see from the table that stock investors have fared much better in the past decades than other investors. But it was not without considerable uncertainty as to what could happen. This is illustrated by the volatility figure that appears in the last column of Table 2. This

FIGURE 1. HOW MONEY GROWS EXPONENTIALLY: ONE-TIME INVESTMENT OF \$1,000 OVER 35 YEARS AT 11%



volatility figure indicates the amount by which actual returns each year varied around the average; the greater the variation, the greater the risk.

The annual returns of small stocks varied the most, while the returns of large-company stocks came in a close second; both of these areas also produced the highest returns over the long term. The annual returns of Treasury bills varied the least, and at the same time they produced the lowest returns.

You can see from Table 2 that rewards tend to go hand-in-hand with risk—the risk/return relationship.

Axiom 4: Manage risk wisely—it cannot be avoided.

Investment risk has two important components: volatility risk and inflation risk.

Volatility risk is the risk that actual returns vary compared to expected returns over time; in general, higher returns go hand-in-hand with greater volatility risk.

Inflation risk relates to a loss in purchasing power through general price inflation. For example, from the inflation rate in Table 2 you can see that between January 1, 1926, and December 31, 2002, the dollar lost more than 90% of its purchasing power. At the end of 2002 it took \$10 to purchase a basket of goods similar to what could have been purchased for \$1 at the beginning of 1926.

While you cannot eliminate either volatility risk or inflation risk, you can minimize both by understanding the nature of investment risk and selecting investments suitable for your investment time horizon. For shorter-term time horizons, volatility risk is more of a concern; for longer-term time horizons, inflation risk becomes a greater concern.

For this reason, money invested for the short term should be invested differently than money invested over the long term. The common error among many individuals who are

saving for retirement is to reduce their average earning rate significantly and thus their accumulated savings by attempting to avoid short-term

earnings volatility. This approach exposes them fully to inflation risk.

For short-term investment periods, the returns from stocks are clearly more volatile (or risky) than from Treasury bills or bonds. However, for longer-term holding periods, the returns from stocks are both less risky and higher than for bonds after adjusting for inflation.

In his recent and influential book, “Stocks for the Long Run,” Jeremy J. Siegel reports on his investigation of inflation and investment returns since 1802 (McGraw-Hill, 2002). He found that over the past 195 years, for every 10-year holding period, the returns earned from stocks exceeded the returns earned for bonds or Treasury bills even in the worst 10-year stock performance period. And for 20-year holding periods, stocks have *never* fallen behind inflation, while bonds and T-bills have fallen 3% per year behind the rate of inflation.

The fact that stocks, in contrast to bonds or T-bills, have never offered investors a negative after-inflation return over holding periods of 20 years or more is extremely significant. Although it might appear to be riskier to hold stocks than bonds, precisely the opposite is true for longer holding periods: The safest long-term investment for the preservation of purchasing power has clearly been stocks, not bonds.

Axiom 5: Diversify, diversify,

TABLE 2. HISTORICAL RETURNS FOR VARIOUS ASSET CLASSES (1926–2002)

	Growth of \$1 (\$)	Average Annual Return (%)	Volatility* (%)
Large-Company Stocks	\$1,775	10.2	20.5
Small-Company Stocks	6,816	12.1	33.2
Long-Term Government Bonds	\$60	5.5	9.4
Treasury Bills	\$17	3.8	3.2
Inflation	\$10	3.0	4.4

**As measured by standard deviation, which is the amount by which actual returns varied around the average; the greater the standard deviation, the greater the volatility.
Source: Ibbotson Associates.*

diversify.

Portfolios should be diversified at all levels. By allocating among the major asset categories (stocks, bonds and cash), you diversify the two kinds of investment risk we identified in Axiom 4.

Risk can further be reduced by diversifying *within* those asset categories. For example, a stock portfolio should be built by investing in the common stock of firms in different industries. Buy only “good quality” firms which will have an increasing demand for their products. Set a goal of 15 to 20 different industries.

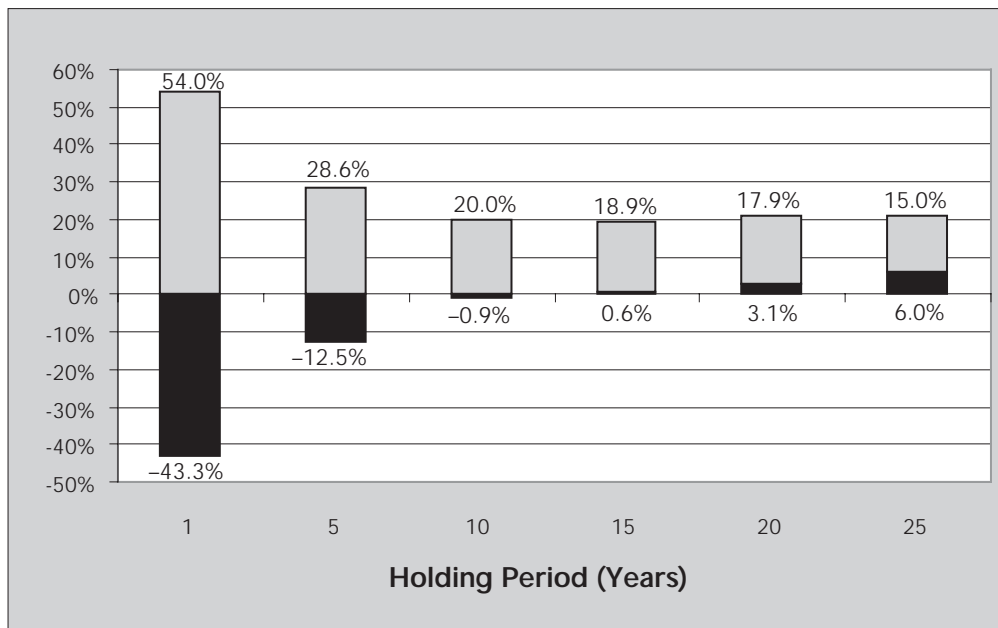
Broad-based mutual funds offer significant diversification benefits to investors in all asset categories.

A solid investment vehicle for the investor who wants to diversify broadly without attempting to purchase individual stocks is to purchase shares in a market index mutual fund, with low management fees. In particular, a single share of an S&P 500 index fund is widely diversified and represents the equity market nicely.

Axiom 6: Maintain a long-term perspective—over time, the stock market rewards the patient investor.

You can see from the accompanying tables that investors are rewarded for assuming some kinds of

FIGURE 2. RANGE OF RETURNS ON COMMON STOCKS BASED ON HOLDING PERIOD (1926–2002)



risk. Then why would you not always invest in common stocks, rather than in other securities, such as bonds?

The answer relates to the length of time you are willing and able to wait for returns. An investor in common stocks must often wait longer to earn the higher returns than those provided by bonds—maybe as long as five to 10 years. In Table 2, we observed a lot more volatility in the annual returns of stocks than for bonds or Treasury bills.

What if an individual invested in a portfolio of large-company stocks for five years or even 15 years? The answer to this question is shown in Figure 2, which provides the highest and lowest rate of return for various investment periods for large-company common stocks (represented by the S&P 500). The average rate of return for all the years from 1926 through 2002 was 10.2%, as was shown in Table 2. However, the best year was a fantastic 54.0% return, while in the worst year it was a loss of 43.3%. But if you look at all of the *five-year* investment periods from 1926 through

2002 (1926–1931, 1927–1932, etc.), the best return would have been reduced to 28.6% and the worst year would not have been so drastic as before, only losing 12.5%. As you extend the investment horizon, the variability in the returns continues to decline. Yet the average return overall is still 10.2%. Thus, an investor will have maintained the same return on average, but reduced the year-to-year fluctuations by holding investments over longer time periods.

Patience is a virtue, even when investing. The market rewards patience.

Axiom 7: Avoid the temptation to time investments based on what you—or the experts—“expect” the overall market to do.

Frequently, you hear an economist or a financial consultant in the news making projections about the financial markets. The individual might offer opinions about the current level of the stock market or about the future of interest rates. He may believe that the market is undervalued or overvalued or that

interest rates will increase in the next quarter. In listening to an expert, you could come away with the distinct impression that he knows what we cannot know—and that his professional expertise allows him to take advantage of his “vision” of the future and make a lot of money.

It is important to understand that this impression, with rare exceptions, is an illusion. Investors, even the professionals, do not

have some “super vision” when it comes to knowing the direction of the markets.

In a 1981 study of 82 large U.S. pension plans, it was found that deciding when to get in and out of the market had little impact on the relative performance of the pension funds. The researchers estimated that market timing accounted for less than 2% of the variation explaining the relative performance of the different investment managers. This study, along with others, indicates that an investor simply cannot consistently identify the best time to invest.

An investor cannot expect to do better by timing investments than if he routinely invests each and every month because the market moves in fits and starts. Missing the few good days because you are out of the market can seriously reduce your return. This point is illustrated in Figure 3. Over the period 1986 through 1995, an investment in the S&P 500 index would have returned 14.8% annually if it remained fully invested for the whole time period. However, if you missed the best 10 days, the return would have been

10.2%, while missing the best 20 days would have resulted in a 7.3% return.

For a more dramatic, longer-term example: Over the last 40 years, a dollar invested for the entire period in large-company stocks would have been worth \$86.65 today, while if you had missed the best 34 months, the investment would have accumulated to only \$4.49.

The point is: Don't worry about timing your investments, instead just invest regularly, and be cautious at listening to all the "experts."

Axiom 8: Know what you are paying for and don't pay for what you don't receive—avoid loads, commissions, and expensive investment advice.

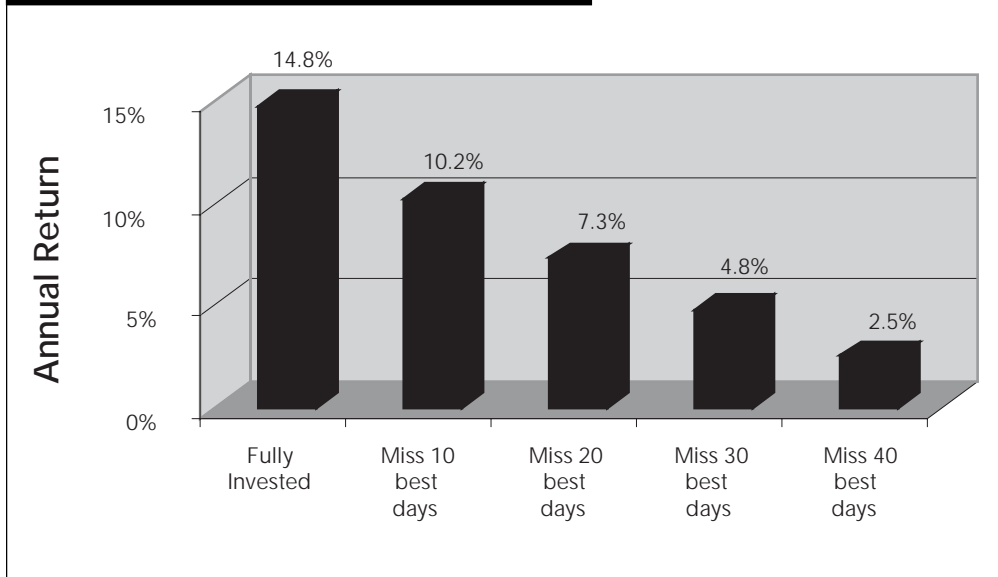
Brokers, distributors and others charge a commission for putting you into mutual funds that, on average, perform below others available. More than 91% of load (commission) funds will also charge you a distribution fee (the shareholder is forced to give up income to pay brokers and distributors for selling shares to new shareholders).

Funds that charge these kinds of loads and fees do not necessarily have higher returns. In fact, none of those charges go to those who are actually managing the portfolio, so you are not paying extra for any kind of management expertise. Why should you pay more in continuing expenses to receive returns that are not necessarily better—particularly since your bottom line return is reduced by those expenses?

Axiom 9: Beware of the experts and "hot hands."

An investor may be surprised to know that he can do better than the professional money managers most of the time. Over several time periods of 10 years, an investment

FIGURE 3. THE S&P 500 (1986–1995): THE EFFECTS ON RETURN OF TRYING TO TIME THE MARKET



in a S&P index fund outperformed the great majority of the actively managed stock funds.

Individual stocks are fine, but require considerable time and expertise. Finding a good mutual fund for long-term investing takes less time and effort and reasonable success can be expected if you do not talk or listen to commissioned brokers.

Stay with mutual funds that have a high (four or five) Morningstar rating, no 12b-1 (distribution fee), low expense ratios, no commission, low turnover, and have an experienced portfolio manager.

No-load no-distribution-fee mutual funds are bought by smart investors; mutual funds with a load (commission) and a distribution fee are *sold* to individuals (who are groping in the dark) by brokers, distributors, and others who have a conflict of interest. If you want to buy a new Cadillac you go to a Cadillac dealer and if you want a new Camry you go to a Toyota dealer, not a Ford or Volvo dealer. No-load mutual fund families advertise in financial publications and give 800 telephone numbers for your use.

Axiom 10: Don't pay taxes unless unavoidable and then pay them later, not sooner.

The current payment of federal income taxes on investment returns is crippling to savings accumulation. For example, \$2,000 saved at the close of each year for 40 years earning 12% grows to \$1,534,182 without federal income taxes. In comparison, the same \$2,000 saved each year at 12% adjusted to an aftertax rate of 8.76%, grows to only \$633,758 over the same time period.

The simplest way for an investor to defer or avoid taxes is through a 401(k) retirement plan, which is available for most corporate employees. Additional tax-favored plans include regular IRAs, Roth IRAs, SEPs, and Keogh plans, of which the advantages and disadvantages are the subject of another article.

Money saved outside of tax-favored retirement plans receives more favorable tax treatment if it is invested in common stocks than in bonds or bank savings accounts or CDs. Increases in the value of common stocks due to a company's retention of earnings is not taxed until the stock is sold, which can result in the deferral of federal income tax for many years. In addition, gains on the sale of common stock are typically taxed at lower rates (generally 20%) than

ordinary income.

In contrast, interest income from ownership of bonds, savings accounts, and CDs is taxed at ordinary tax rates at the time of receipt, which is normally annually. The combination of federal income taxes and inflation sometimes operates to produce a loss in purchasing power to an investor even while an investor is receiving interest income.

STAYING ON TRACK

Unfortunately, the 10 axioms of effective investing are easier to understand than to implement. The first big danger you may face is one of procrastination. For many indi-

viduals, it is easier to plan to save and invest next month rather than to begin immediately.

Useful to meeting this challenge is to visualize the peace of mind and security that comes with maintaining a disciplined, successful savings program.

After you have begun to save and invest successfully and consistently, your next big danger will be your urge to flee the market when the inevitable market downturns occur—like those of today. Fear of heavy loss is a powerful motivator to scuttle your investing program at the worst possible time.

You can overcome the natural investment anxieties that occur in a

down market by reviewing again the long-term history of investment returns, and by reframing mentally the decline in market prices as a buying opportunity.

A third danger will be that of enticing investments that promise rapid savings growth through rare and unusual investment opportunities. But remember—if an investment opportunity seems too good to be true, it probably is.

You can avoid these dangers by following the axioms presented here. Just remember: When any of the axioms are violated, it is done at the risk of being derailed from the ultimate objective of accumulating a more-than-adequate fund for retirement. ♦

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