THE H. KENT BAKER INVESTMENTS SERIES

THE SAVVY INVESTOR'S GUIDE TO BUILDING WEALTH THROUGH TRADITIONAL INVESTMENTS

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INVESTOR IN PEOPLE

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"The most valuable of all talents is that of never using two words when one will do."

—Thomas Jefferson

In writing *The Savvy Investor's Guide to Building Wealth Through Traditional Investments*, we tried to keep Thomas Jefferson's advice in mind. This book is short but filled with many powerful ideas. Its publication would have been impossible without the support of several parties. We appreciate the professionalism of everyone at Emerald Publishing, especially Charlotte Maiorana (Senior Editor). Charlie Wilson (Associate Editor), Sophie Barr (Senior Content Editoro and S. Rajachitra (Senior Project Manager). We also owe our respective institutions – Kogod School of Business at American University, College of Business and Public Policy at the University of Alaska Anchorage, and Frank G. Zarb School of Business at Hofstra University – a debt of gratitude. Finally, we thank our families for their support and understanding: Linda and Rory Baker; Anna Nofsinger; and Terry, Harrison, Teresa, Robin, Kate, and Hudson Spieler.

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INTRODUCTION

Would you like to be a millionaire or better yet a multi-millionaire? If you're like most people, your answer is "yes." This goal is not beyond your reach. As Morton Shulman once quipped, "To make a million, start with $900,000." However, most people don't have the luxury of starting with this amount of money so let's take a hypothetical example. Assume you have a defined contribution plan in which both you and your employer deposit a total of $158.13 at the end of every month into an S&P 500 Index fund that earns a 10% yearly rate of return. If you don't withdraw any money along the way, how much money do you have in your fund after 40 years? Take a guess. You'd have slightly more than $1 million. You'd be a millionaire. Although the assumed inputs may not mirror your situation, the key point is that regular investing and the power of compounding leads to higher wealth accumulation over time. Thus, small efforts can create big results in terms of your wealth. Keep in mind, however, that the purchasing power of your money would be much less 40 years from now than today due to price inflation.

> *"Money, if it does not bring you happiness, will at least help you be miserable in comfort."*
>
> Helen Gurley Brown

How can you build wealth? The answer is simple but not easy. It is more common sense than magic secret. You become swealthy by starting early, spending less than you make, managing risk, and saving and investing regularly and wisely over the long term. Along the way, focus on what you can control, such as the amount of risk you're willing to take, the costs you're willing to incur as well as your investment horizon, asset allocation, and behavior. The single greatest factor in growing your long-term wealth is the rate of return you get on your investment, which is determined over time by the market. This roadmap to wealth is straightforward, but it requires discipline and patience. Little by little, a little becomes a lot.

Unfortunately, many people lack sufficient discipline and patience. Others wait for some fortuitous event to occur such as winning a lottery or inheriting a large sum of money. For most people, such events never occur. Consequently, they aren't wealthy and will never be. It's sad, because many of them could have become wealthy if they'd only been proactive and taken the necessary steps to building wealth. Don't be one of these people. Building wealth takes planning and requires both productive work and dedication.

> *"Too many people spend money they haven't earned, to buy things they don't want, to impress people they don't like."*
>
> Will Smith

As an investor, you face many challenges. Savvy investors turn challenges into opportunities. After you eliminate high consumer debt, especially high-interest debt, and build up sufficient savings to handle emergencies, you need to decide how and where to invest your hard-earned money. Most people don't know much about investing and some don't even know

> *"Acknowledging what you don't know is the dawning of wisdom."*
> Charlie Munger

where to begin. As a result, they either never get started investing or make costly mistakes. A good way to start building wealth is to invest in traditional investments – stocks, bonds, and cash or cash equivalents. Stocks and bonds are the heartbeat of Wall Street. You can invest in a single security, which most individual investors don't do, or in a *pooled investment vehicle*, which combines the funds of many investors for the purposes of investment. Prepackaged products such as index mutual funds or exchange-traded funds offer economies of scale, which provide lower trading costs per dollar of investment, diversification, and professional money management. When you invest in stocks and bonds, you can receive a future income stream in terms of dividends and interest, as well as the alluring prospect of capital growth and compounding returns over time. Creating wealth with these financial instruments is tied to the market's performance, which you can't control. Additionally, one of the most powerful avenues to invest and build wealth is through retirement plans.

> *"Building wealth is a marathon not a sprint. Discipline is the key ingredient."*
> Dave Ramsey

> *"If your ship doesn't come in, swim out to meet it."*
> Jonathan Winters

Before you begin your wealth-building journey, you need to be honest about what you know and what you don't know about investing. *The Savvy Investor's Guide to Building Wealth Through Traditional Investments* is intended to help you learn about traditional investments and to become a better investor, especially if you are a novice or an inexperienced investor. As Maya Angelou once wrote, “Do the best you can until you know better. Then when you know better, do better.” Thus, as Robert Kiyosaki notes, “Financial freedom is available to those who learn about it and work for it.”

1

BUILDING WEALTH AND ACHIEVING FINANCIAL FREEDOM

"You can be young without money, but you can't be old without it."

—Tennessee Williams, American playwright

"Who Wants to Be a Millionaire?" was a popular American television game show based on the same-titled British program. Not surprisingly, few contestants walked away with the top prize. Winning $1,000,000 is difficult! Of course, nearly everyone would like to be a millionaire but how can this be accomplished besides winning a game show or lottery? Fortunately, several paths are available to becoming rich.

A recent study of wealthy individuals identified three common ways they built their fortunes. *Saver-investors* focus on having no debt, living well below their means, and saving and investing for many years. *Virtuosos* are those who are the "best of the best" in their career, industry, or profession. They work for large, publicly held companies that have stock options or own their own highly profitable businesses. *Dreamers* pursue a big dream and make it a reality, which lead to some massive gain or income. If you want to be rich, you need to select a path that's right for you and stick with it for many years. With a few exceptions, each path requires considerable time to accumulate wealth.

This book follows the first path by focusing on saver-investors. Its primary goal is to discuss how investors, especially novice investors, can use their financial capital to build wealth with traditional investments. Savvy investors can predictably accumulate wealth with some basic strategies, financial knowledge, and patience. In other words, everyone has the potential of building wealth and some can become millionaires or even multi-millionaires and achieve financial freedom.

This chapter discusses the difference between income and wealth, ways to reduce and estimate retirement expenses, and the impact of inflation on future purchasing power. It offers realistic scenarios to start your journey to saving and investing more, spending less, and increasing your wealth.

1.1. WHAT IS A MILLIONAIRE?

For many people, the term "millionaire" conjures up images of extremely wealthy people enjoying the sun on their private yacht. The news media bombard us with pictures of the rich and famous including millionaire athletes, entertainers, and business executives. These images seem distant from the lives of most hardworking everyday people. Let's examine the definition of a millionaire a bit closer. Traditionally, a millionaire is someone with net assets greater than \$1,000,000 excluding the equity in a residence. Thus, if you can accumulate those seven figures you too can join the "two comma" club with \$1,000,000.

At one time, becoming a millionaire was the epitome of success. Today, some of the luster of being a millionaire has diminished because it's almost commonplace. During 2018 about 11.8 million households in the United States consisted of millionaires. This number represents about 3% of the US population. Of course, some people are mega rich because they're members of the ultra-exclusive "three comma" club with at least $1,000,000,000. The United States has the most billionaires in the world followed by China.

Over time, the term "millionaire" has been shifting to signify individuals with an annual salary of $1 million or more. According to the Internal Revenue Service, you'd need to earn about $500,000 per year to be part of the top 1% of earners. The media talk about the "millionaire's tax" on high-income earners and additional real estate taxes on expensive homes. Some politicians have proposed a "wealth tax" on the so-called "1%." This definition of a millionaire is certainly a much higher standard with only about 1 in 400 US households reaching this elusive income mark. Clearly, the definition is shifting over time to identify the true elite earners. Although becoming a millionaire is a lofty goal, this chapter focuses on the traditional definition. Savvy investors know that developing a consistent investment plan using traditional asset classes can potentially help to accumulate the first million, then the second million, and so on. Of course, building wealth doesn't happen overnight. It's achievable but involves taking greater risks to gain higher expected returns.

1.2. CAN YOU RETIRE WITH A MILLION DOLLARS AND LIVE COMFORTABLY?

This is truly the "million dollar" question. The goal of investing is to accumulate assets to improve or maintain your lifestyle, particularly in retirement. As previously noted, no "one size fits all" approach is available to building wealth or

Table 1.1. Factors Affecting Retirement.

Factor	Change in Retirement
Retire later	More comfortable
Withdraw more	Less comfortable
Longer life expectancy	Less comfortable
Higher tax rate/location	Less comfortable
Larger bequest	Less comfortable

becoming a millionaire. The right approach for you depends on several important factors such as your expected time horizon, spending patterns, tax status, and planned bequest to heirs. As a starting point, you should note some important but general observations in the Table 1.1.

To get a sense of your comfort zone, consider the projected withdrawals in retirement based on the following assumptions (rounded):

Funds at retirement	$1,000,000
Retirement age	67
Life expectancy	20 years
Planned inheritance	none
Earnings rate	4%
Tax rate	15%
Annual withdrawals	$62,500 after taxes

The final result allows you to spend $62,500 each year in retirement for 20 years. At first glance, that sounds like a livable amount, but the analysis ignores inflation. Prices won't remain the same during the 20 years of retirement. Assuming inflation of 3% per year, a more realistic estimate of your actual purchasing power would be closer to $48,000 per year.

1.3. WHAT TIPS CAN HELP YOU BECOME A MILLIONAIRE?

> *"If inflation continues to soar, you're going to have to work like a dog just to live like one."*
> George Gobel

Here are the "big four" tips on becoming a millionaire as a saver-investor: (1) save more, (2) spend less, (3) limit taxes, and (4) invest wisely.

- *Save more*. The first tip seems obvious: save more of your earnings. The more you save, the less risk you need to take to increase your wealth. Although most saver-investors have a modest income, they often save 20% or more of their salary. As discussed in later chapters, you should make sure to save at least enough to get your employer's 401(k) match, if you're part of a defined contribution plan. Think of your employer's contribution to your retirement plan as "free money." To get this "free money," you need to contribute a minimum amount specified in your sponsor's plan.

  According to an old adage, "A penny saved is a penny earned." In other words, if you spend less, you can save more. And the savings is likely to grow if invested wisely so a penny saved can become two or more pennies in the future.

- *Spend less*. The second tip is to spend less. Savvy saver-investors live below their means. As simple as this advice sounds, it's not easy to follow given the convenience of credit cards and "buy now, pay later" offers. In fact, the average credit card debt per US household was $8,398 in June 2019, which is $1.07 trillion in total credit card debt divided by 128 million US households. Spending less requires controlling expenses and being disciplined such as sticking to a budget. Otherwise, savings and retirement accounts can dwindle quickly.

- *Limit taxes*. The third tip is to reduce your tax bill. This step can be a complicated issue and is discussed in more detail in later chapters. For now, the idea that lowering current taxes and/or deferring taxes is good. Sometimes, you can eliminate some taxes entirely based on lifestyle choices such as by installing solar panels to get tax credits, moving to a state with no state income tax, or taking advantage of the gift tax exclusion. Under the US tax code, if the amount stays below the gift tax exclusion, you won't have to worry about any tax. For example, the annual gift tax exclusion in the United States for 2020 is $15,000.

> *"I'm proud to be paying taxes in the United States. The only thing is, I could be just as proud for half the money."*
> Arthur Godfrey

- *Invest wisely*. Investing wisely is what savvy investors do and that's the main focus of this book. By properly using traditional investments you can build wealth over time. To invest wisely, you need to not only to have sufficient knowledge but also the discipline to carry out your plans.

> *"I believe that through knowledge and discipline, financial peace is possible for all of us."*
> Gordon Ramsey

1.4. HOW CAN YOU SAVE MORE AND SPEND LESS?

People are tempted daily with instant gratification purchases. It takes discipline to spend less and live below your means. Try to go just one day without spending money while out of your house – walk/bike to work or pack your own lunch – and you'll see spending less is not so easy! As many know, those fancy latte drinks can add up quickly.

A safe, prudent guideline to follow is the "pay yourself first" rule. Specifically, make sure that you immediately invest some part of your paycheck before it touches your hands. For example, contribute to your employer 401(k) plan with a direct payroll deduction or your own individual retirement account (IRA) with withdrawals from your checking account after your paycheck direct deposit.

Another easy "pay yourself first" idea is to establish a college savings plan known as a 529 plan with small, frequent contributions. Although the rules about current tax deductions for 529 plans vary by state, many states allow a state tax deduction. Your investment is immediately earning a return while reducing your tax bill. Regardless of where you live, all 529 plans allow the funds to grow tax-free, and the withdrawals are tax-free when used for qualified higher education expenses. The chance to have years of tax-free growth is highly attractive.

Another large expense individuals pay over a lifetime is interest on debt, especially credit card debt. When you buy a car, house, and other products, you may be using debt. The interest paid on that debt is related to your personal credit score. A higher credit score reduces the interest rate owed on the debt and thus reduces the payments. Savvy investors pay their bills on time to keep a high credit score and save thousands in interest payments over the years.

1.5. WHAT IS THE DIFFERENCE BETWEEN INCOME AND WEALTH?

To the average person, the terms income and wealth are interchangeable. Although income and wealth are related ideas, they have important differences. Income represents the inflows from wages (mostly) and investments (much less) for the typical hardworking person. Wealth is the difference between your assets such as retirement accounts, savings accounts, life insurance policies, and home and your liabilities such as your mortgage, student loan, and credit card balances. Income is always positive, but wealth can be negative even for educated professionals.

> *"Wealth is largely the result of habit."*
> John Jacob Astor

Income is more normally distributed than wealth. That is, income looks more like the "bell curve" with most observations clustered near the middle. Some outliers exist such as high-level business executives and professional athletes that earn extremely high incomes. In contrast, wealth is distributed in a highly unequal fashion, with the wealthiest 1% of US families holding about 40% of all wealth and the bottom 90% of families holding less than 25% of all wealth. Of course, you can probably name some extreme outliers such as individuals who have accumulated billions of dollars of wealth. By way of comparison, according to the US Bureau of Labor Statistics (BLS), the median wage for American workers in the first quarter of 2019 was $905 per week or $47,060 per year for a 40-hour workweek. However, the bottom quarter of wealth is negative. Negative wealth doesn't mean that the bottom 25% of the population is hopelessly poor. For example, young earners may have positive, even high, income but negative wealth as they pay back student loans and consumer debt. Over time, your income is likely to rise into your 50s and 60s and then drop as you enter retirement.

Wealth, however, starts out small or negative but accumulates over time. Wealth typically reaches its maximum just before you stop working. Although the value of your portfolio