NED'S INSIGHTS

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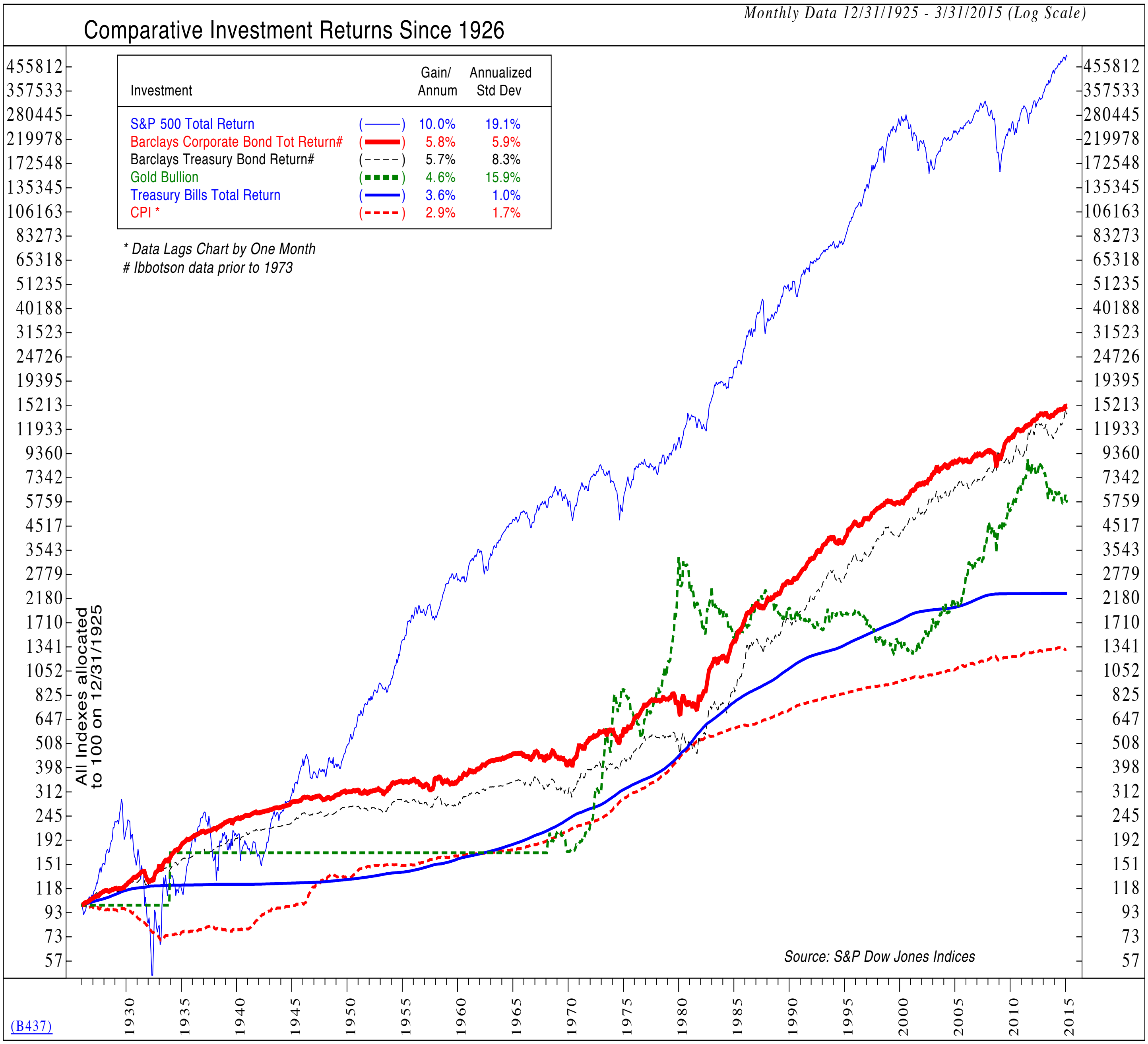
TREND UPDATE

S&P 500 = 2102.06

REFERENCED CHART LINKS

Compounding Returns and Making the Trend Your Friend

My philosophy in making money and how the trend fits into that is my subject today. I basically believe that most people get rich by compounding interest and probably the best investment to compound is the stock market. The reason I make that statement is shown on B437 (below). This is a chart of the history of six "investments" over the past 90 years. There really has been no contest. Stocks have returned 10% per annum, almost double most other investments. We did not include houses, but the median home price, for the historical data we have, would be in the middle of the chart.



What does a 10% compounded return mean? One of my favorite studies on the magic of compound interest is featured below. Two investors opened IRAs. The first put only $16,000 into investments ($2,000 per year for eight consecutive years starting at age 19) and at age 65, due to compounding returns in an IRA at 10%, the $16,000 had grown to over one million dollars. The second 19-year old invested $78,000 starting at $2,000 per year at age 27 (at 10%); at age 65 that investor had a gain of only $805,000.

The lesson applies not only to savers and investors but also to debtors who get hit owing compound interest. The U.S. government (actually, we tax payers) are getting hit with compounding interest charges. In the year ending September 2014, interest payments on the federal debt were $447.9 billion (over 11% of total government expenditures).

The classic example of the virtues of compounding returns goes back to 1626 when the Dutch purchased Manhattan Island from local American Indians for 60 guilders, or in excess of $25 at today's exchange rates. The question debated by statisticians is this: who got the better deal – the white men or the American Indians?

The settlers received land which is today part of one of the greatest and richest cities in the world; but the American Indians received 60 guilders. Had the American Indians invested their 60 guilders in an IRA with a combination of common stocks and government bonds (which have yielded 7.9% total return since 1926), the $25 would now be worth $175 trillion, with which they could purchase not only all the real estate in New York City but all the real estate in the U.S. Moreover, they would have plenty left over to purchase all the stocks listed on U.S. stock exchanges.

Compounding returns on investments is one of the best ways to get rich. Compounding interest on debt is a good way to go broke.

	Investor A $2,000 per year for first eight years Total Investment $16,000		**Investor B** $2,000 per year for remaining 39 years Total Investment $78,000	
Age	Tax Deferred Contribution	Year-End Value	Tax Deferred Contribution	Year-End Value
19	2,000	2,200	0	
20	2,000	4,620	0	
21	2,000	7,282	0	
22	2,000	10,210	0	
23	2,000	13,431	0	
24	2,000	16,974	0	
25	2,000	20,872	0	
26	2,000	25,159	0	
27	0	27,675	2,000	2,200
28	0	30,442	2,000	4,620
29	0	33,487	2,000	7,282
30	0	36,835	2,000	10,210
31	0	40,519	2,000	13,431
32	0	44,571	2,000	16,974
33	0	49,028	2,000	20,872
34	0	53,930	2,000	25,159
35	0	59,323	2,000	29,875
36	0	65,256	2,000	35,062
37	0	71,781	2,000	40,769
38	0	78,960	2,000	47,045
39	0	86,856	2,000	53,950
40	0	95,541	2,000	61,545
41	0	105,095	2,000	69,899
42	0	115,605	2,000	79,089
43	0	127,165	2,000	89,198
44	0	139,882	2,000	100,318
45	0	153,870	2,000	112,550
46	0	169,257	2,000	126,005
47	0	186,183	2,000	140,805
48	0	204,801	2,000	157,086
49	0	225,281	2,000	174,995
50	0	247,809	2,000	194,694
51	0	272,590	2,000	216,364
52	0	299,849	2,000	240,200
53	0	329,834	2,000	266,420
54	0	362,817	2,000	295,262
55	0	399,099	2,000	326,988
56	0	439,009	2,000	361,887
57	0	482,910	2,000	400,276
58	0	531,201	2,000	442,503
59	0	584,321	2,000	488,953
60	0	642,753	2,000	540,049
61	0	707,028	2,000	596,254
62	0	777,731	2,000	658,079
63	0	855,504	2,000	726,087
64	0	941,054	2,000	800,896
65	0	1,035,160	2,000	883,185
Total Invested		(16,000)		(78,000)
Net Gains		$1,019,160		$805,185

Interest Rate = 10%

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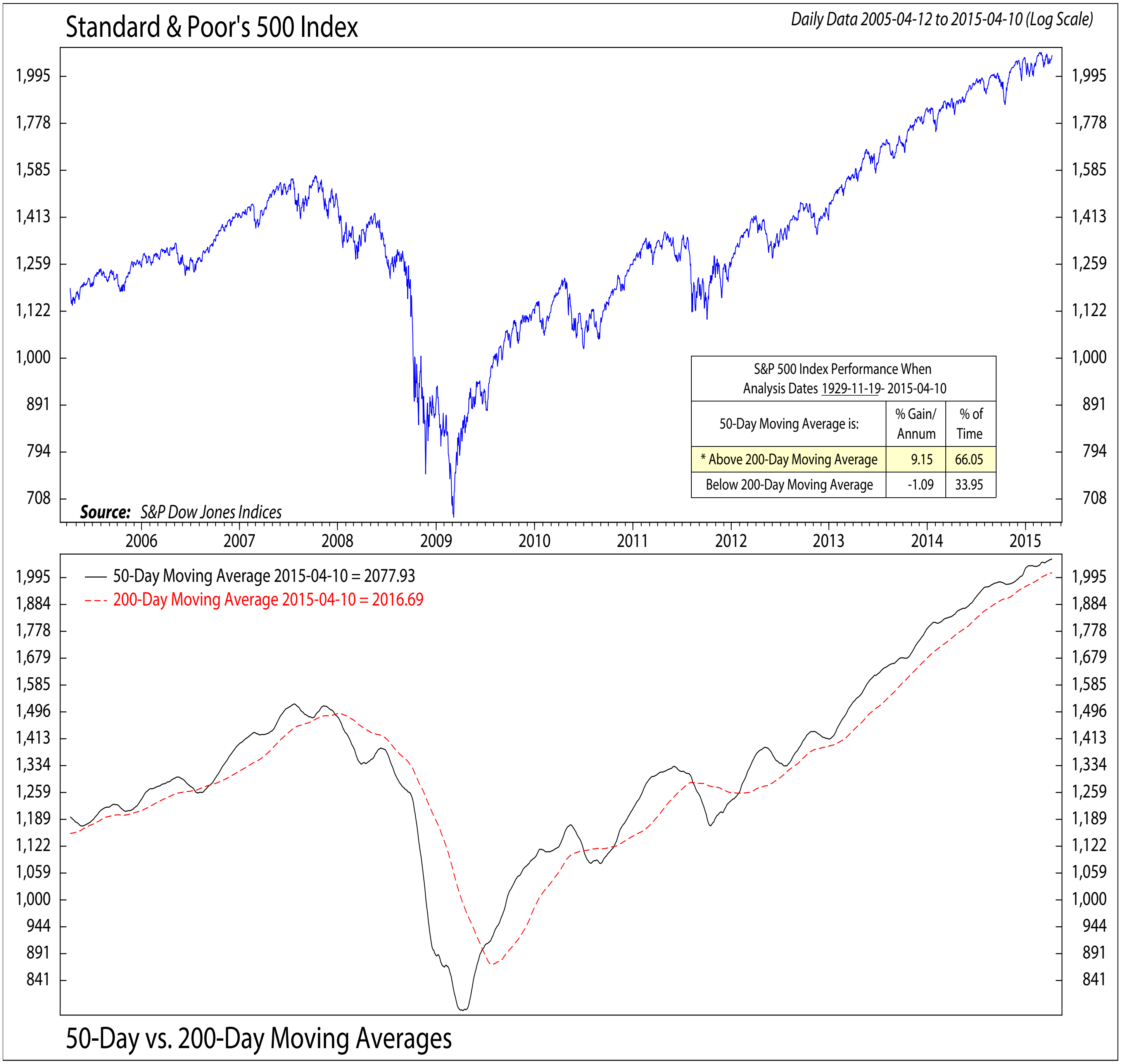
So the main key to getting wealthy is to compound investment returns. And long-term investing in stocks has certainly been one of the best choices. But one must also find a method of investing that one can live with – that meets one's psyche. It's important to understand the market does not go up constantly over time.

These examples used constant annual gains to illustrate how compounding works. I've also learned this about compound returns. If you buy something at $100, and it goes to $50, that is a 50% loss, but it will take a 100% advance to just get back to even. So when asked how to make money, Warren Buffett said he had two rules: "Rule #1 – Don't lose money. Rule #2 – Don't forget Rule #1."

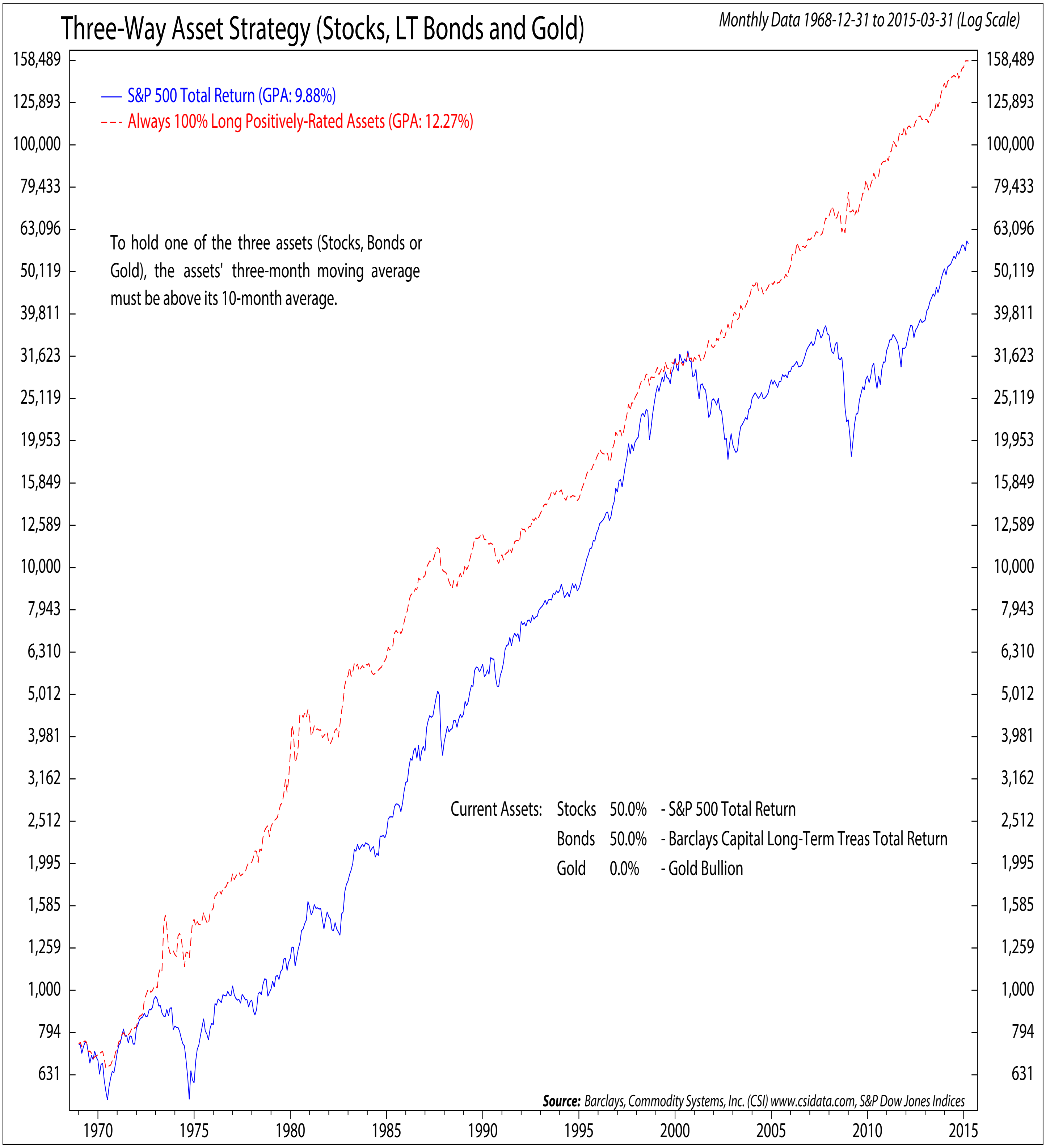
I don't like to take big losses. For me, this means the trend is your friend or "don't fight the tape." As one example of this, note DAVIS128A (below). Here, we've calculated how the market performed whenever the 50-day smoothing of the trend goes above the 200-day smoothing. We used data going back to 1929 and all the net gains in stock prices came when the trend was upward as measured by this simple trend formula. The results are based upon price alone and do not include dividends or interest earned when out of stocks. The reason this indicator worked is that it lets profits run, but cuts losses short, a great money management rule.

The investment business is a business of making mistakes. The only difference between the winners and losers is the winners make small mistakes while the losers make big mistakes. Please keep in mind that what worked in the past may not always work in the future, and it's important to monitor any investment strategy continuously.



DAVIS128A

But I also like to diversify. I think it cuts risks. So I don't just want to be limited to compounding stock returns. The next chart illustrates the returns one could have enjoyed using a similar formula as DAVIS128A, but using it to allocate a portfolio among stocks, bonds, and gold. Just being in these three investments during uptrends has beaten the record of just being long stocks (DAVIS221, below). This indicator starts in 1968 because that is when gold started trading freely. Why did this indicator work? As I learned in Economics 101, prices are determined by supply and demand. And prices are also the equilibrium points of supply and demand. Thus, if prices are rising, demand must be greater than supply, and I want to be in. To not lose money, I hedge my risks when we get into downtrends.



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