The Elements of Investing
by Burton G. Malkiel and Charles D. Ellis

Mr. Malkiel is a professor of economics at Princeton. Mr. Ellis had a long career as an investment consultant. Each has written extensively on investing and saving. By the way: If you are ever interested in investing seriously, as I hope all of you will someday, you would, in my opinion, be well advised to read Mr. Malkiel’s book A Random Walk Down Wall Street. Unless otherwise indicated, I added the footnotes.

I: Save

Save. The amount of capital you start with is not nearly as important as organizing your life to save regularly and to start as early as possible. As the sign in one bank read: “Little by little you can safely stock up a small reserve here, but not until you start.”

The fast way to affluence is simple: Reduce your expenses well below your income—and Shazam!—you are affluent because your income exceeds your outgo. You have “more”—more than enough. It makes no difference whether you are a recent college graduate or a multimillionaire. We’ve all heard stories of the schoolteacher who lived modestly, enjoyed life, and left an estate worth over $1 million—real affluence after a life of careful spending. And we know one important truth: She was a saver.

But it can also go the other way. A man with an annual income of more than $10 million—true story—kept running out of money, so he kept going back to the trustees of his family’s huge trusts for more. Why? Because he had such an expensive lifestyle—private plane, several large homes, frequent purchases of paintings, lavish entertaining, and on and on. And this man was miserably unhappy.2

In David Copperfield, Charles Dickens’s character Wilkins Micawber pronounced a now-famous law:

Annual income 20 pounds, annual expenditure 19 pounds 19 [shillings] and 6 [pence], result happiness. Annual income 20 pounds, annual expenditure 20 pounds ought and 6, result misery.

Saving is good for us—for two reasons. One reason for saving is to prevent having serious regrets later on. As the poet John Greenleaf Whittier wrote: “Of all sad words of tongue and pen, the saddest are ‘It might have been.’”3 “I should have” and “I wish I had” are two more of history’s saddest sentences.

Another reason for saving is quite positive: Most of us enjoy the extra comfort and the feeling of accomplishment that comes with both the process of saving and with the results—having more freedom of choice both now and in the future. No regrets in the future is important or will be, to all of us. No regrets in the present is important, too. Being a sensible saver is good for you, but deprivation is not. So don’t try to save too much. You’re looking for ways to save that you can use over and over again by making these new ways your new good habits.4

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1 Well, maybe you haven’t, but I have. If you go to <http://www2.cortland.edu/news/detail.dot?id=176872> or search for “Catherine Stewart Jones Community Foundation Central Georgia” you will see a couple of examples.
2 You can probably think of a couple of professional athletes or musicians who have ended up in bankruptcy despite making enormous fortunes in their careers.
3 This line is from a poem entitled “Maud Muller,” written in 1856. [Note in source.]
4 Or as Malcolm Gladwell suggests in Blink, you might try to get taller. Being six feet tall adds over $5,000 a year to your income because our society prefers taller people—so they enjoy better-paying careers. [Note in source.] Alas, this rule does not apply to public school teachers.
The real purpose of saving is to empower you to keep your priorities—not to make you sacrifice. Your goal in saving is not to “squeeze orange juice from a turnip” or to make you feel deprived. Not at all! Your goal is to enable you to feel better and better about your life and the way you are living it by making your own best-for-you choices. Savings can give you an opportunity to take advantage of attractive future opportunities that are important to you. Saving also puts you on the road to a secure retirement. Think of saving as a way to get you more of what you really want, need, and enjoy. Let saving be your helpful friend.

FIRST DO NO HARM

The first step in saving is to stop dissaving—spending more than you earn, especially by running up balances on your credit cards. There are few, if any, absolute rules in saving and investing, but here’s ours: *Never, never, never take on credit card debt.* This rule comes as close as any to being an inviolable commandment. Scott Adams, the creator of the Dilbert comic strip, calls credit cards “the crack cocaine of the financial world. They start out as a no-fee way to get instant gratification, but the next thing you know, you’re freebasing shoes at Nordstrom.”

Credit card debt is great—but not for you (or any other individual). Credit card debt is great for the lenders, and only the lenders. Credit cards are a wonderful convenience, but for every good thing there are limits. The limit on credit cards is *not* your announced “credit limit.” The only sensible limit on credit card debt is zero.

Credit card debt is seductive. It’s all too easy to get onto the slippery slope—and slide down into overwhelming debts. You never—well, almost never—get asked to pay off your debt. The bank will “graciously” allow you to make low monthly payments. Easy. Far too easy! Your obligations continue to accumulate and accumulate until you get The Letter, saying you have borrowed too much, your interest rate is being increased, and you are required to switch, somehow, from money going to you to money going from you to the bank. You are not just in debt, you are in trouble. If you don’t do what the bank now says you must do, legal action will be taken. Be advised! Never, never, never use credit card debt.

START SAVING EARLY: TIME IS MONEY

The secret of getting rich slowly but surely is the miracle of compound interest. Albert Einstein is said to have described compound interest as the most powerful force in the universe. The concept simply involves earning a return not only on your original savings but also on the accumulated interest that you have earned on your past investment of your savings.

Why is compounding so powerful? Let’s use the U.S. stock market as an example. Stocks have rewarded investors with an average return close to 10 percent a year over the past 100 years. Of course, returns do vary from year to year, sometimes by a lot, but to illustrate the concept, suppose they return exactly 10 percent each year. If you started with a $100 investment, your account would be worth $110 at the end of the first year—the original $100 plus the $10 that you earned. By leaving the $10 earned in the first year reinvested, you start year two with $110 and earn $11, leaving your stake at the end of the second year at $121. In year three you

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5 The idea that returns vary cannot be emphasized enough. To take two recent examples, in 2010 one commonly used index of stock market performance, the S&P 500, was up 14.32%. In 2008, the same index was down 37.22%.
earn $12.10 and your account is now worth $133.10. Carrying the example out, at the end of 10 years you would have almost $260—$60 more than if you had earned only $10 per year in “simple” interest. Compounding is powerful.

THE AMAZING RULE OF 72

Do you know the amazing Rule of 72? If not, learn it now and remember it forever. It’s easy, and it unlocks the mystery of compounding. Here it is: \( X \times Y = 72 \). That is, \( X \) (the number of years it takes to double your money) times \( Y \) (the percentage rate of return you earn on your money) equals… 72.

For anyone whose attention is attracted by the Rule of 72, the obvious follow-on is surely compelling: If a 10 percent rate of return will double your money in 7.2 years, it will double your money again in the next 7.2 years. In less than 15 years (14.4 years to be exact), you’ll have four times your money—and sixteen times your money in 28.8 years.

What rate of return would be required to double your money in 12 years?

If someone told you they could double your money in 8 years, what rate of return would they be offering?

Today interest rates are quite low. How long would it take you to double your money if you put $1000 in a one-year CD paying 1.1% interest?

So if you’re 25 and you skip one glass of wine at a fancy restaurant today, you might celebrate with your spouse the benefit of compounding with a full dinner at that same restaurant 30 years from now. The power of compounding is why everyone agrees that saving early in life and investing is good for you. It is great to have the powerful forces of time working for you—24/7.

Time is indeed money, but as George Bernard Shaw once said, “Youth is wasted on the young.” If only we could all train ourselves at a young age to know what we know now. When money is left to compound for long periods, the resulting accumulations can be awe inspiring. If George Washington had taken just one dollar from his first presidential salary and invested it at 8 percent—the average rate of return on stocks over the past 200 years—his heirs today would have about $8 million. Think about this every time you see Washington on a U.S. dollar bill.

Benjamin Franklin provides us with an actual rather than a hypothetical case. When Franklin died in 1790, he left a gift of $5,000 to each of his two favorite cities, Boston and Philadelphia. He stipulated that the money was to be invested and could be paid out at two specific dates, the first 100 years and the second 200 years after the date of the gift. After 100 years, each city was allowed to withdraw $500,000 for public works projects. After 200 years, in 1991, they received the balance—which had compounded to approximately $20 million for each city. Franklin’s example teaches all of us, in a dramatic way, the power of compounding. As Franklin himself
liked to describe the benefits of compounding, “Money makes money. And the money that money makes, makes money.”

A modern example involves twin brothers, William and James, who are now 65 years old. Forty-five years ago, when William was 20, he started a retirement account, putting $4,000 in the stock market at the beginning of each year. After 20 years of contributions, totaling $80,000, he stopped making new investments but left the accumulated contributions in his account. The fund earned 10 percent per year, tax free. The second brother, James, started his own retirement account at age 40 (just after William quit) and continued depositing $4,000 per year for the next 25 years for a total investment of $100,000. When both brothers reached the age of 65, which one do you think had the bigger nest egg?

• William’s account was worth almost $2.5 million
• James’ account was worth less than $400,000.

William won the race hands down. Despite having invested less money than James, William’s stake was over $2 million greater. The moral is clear; you can accumulate much more money by starting earlier and taking greater advantage of the miracle of compounding.

We could run through dozens of other examples using actual stock market returns. One investor might start early but have the worst possible timing, investing at the peak of the stock market each year. Another investor starts later but is the world’s luckiest investor, buying at the absolute bottom of the market every year. The first investor, even though she may have invested less money and had the worst possible timing, accumulates more money.

Luck in picking the right time to invest is all well and good, but time is much more important than timing. There is always a good excuse to put off planning for retirement [and the future generally]. Don’t let it happen to you. Put time on your side. To get rich surely you have to do it wisely—which means slowly—and you will have to start now.6

Like all financial tools, the Rule of 72 needs to be applied wisely. It’s great when it’s working for you but ghastly when working against you. That’s what makes credit card balances so dangerous. With credit card debt, 18 percent is the “normal” interest rate charged. And if you don’t pay promptly, you’ll soon be paying interest on interest—and interest on interest on interest.

Credit card debt is the exact opposite of a great investment. Wouldn’t you like to have an investment that compounded at such a rapid rate? Of course you would. We all would. At 18 percent, a debt doubles in just four years—and then redoubles again in the next four years. Ouch! That’s four times as much debt in just eight years—and it’s still compounding! That compounding is why banks have distributed credit cards so widely to people they don’t even know. And that’s why you should never ever use any credit card debt.

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6 Or as soon as you have a real job, anyway.