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THE VIEW

"If you hold a cat by the tail you learn things you cannot learn any other way." - Mark Twain

The Rule of 72

This is actually fairly straightforward and simple. The rule of 72 states that if you take the annual rate of return on your investment and divide it into 72 the result will be the number of years it will take to double your money. For example, if Mrs. Jones earns 8% on her $100,000 investment every year, her money will double to $200,000 in 9 years. This is a very close approximation of reality and is, therefore, used in finance very frequently for quick calculations on determining payoffs and goal setting. Although this is a useful tool, it does not account for taxes, inflation and reinvestment risk (the risk of reinvesting the annual return of 8% at the same rate). While these factors can certainly affect the outcome, the formula is still a fairly good measure to track the progress you've made toward your goals. For instance, if you are 48 and have accumulated $400,000 in a 401(k) and are pretty certain you can achieve a 6% annual rate of return, you should have close to $800,000 by the time you are 60 years old. If your goal is to have $1 million by the time you are 60 then you know you must save and invest to achieve the $200,000 shortfall. This may not be as challenging knowing you have 12 years to continue contributing and the effect of compounding to help you along.

Should I Pay Off My House?

It's amazing how often we hear this question from our clients. The history of answers from the financial community over the last 25 years tells us why. There is so much conflicting advice on this one issue alone that the real good answers are muddled in with all the rest. Although there's no one right answer to this question, there are a few simple things to consider that generally lead me to say, "Pay it off"! The first thing to consider is that for most people we are talking about their primary residence. Remember this one thing: if you are paying on it, it's a *liability,* if it is paying you, it's an *asset.* If we're talking about your primary residence, generally you do not want to continue this liability in retire-

ment, nor do you want to be forced to sell and move (even though this may be your intention). Second, look at the rate of return you're *certain* you can achieve with your capital; if it is lower than your mortgage interest rate it makes economic sense to pay off your mortgage. Remember, paying off your mortgage results in a **tax-free** rate of return equal to the mortgage rate. Often times I'll hear "… but what about the tax break?" to which I respond that either the bank gets the interest on the mortgage or the taxman gets the tax, but either way those dollars are not in *your* pocket. If you derive comfort from having those extra dollars on hand and do not want to relinquish them to pay off your mortgage, think about paying off your mortgage and getting a home equity line of credit that would put low cost dollars at your disposal, but would cost little to nothing if it was not drawn on.

Deflationary Economics

Have you used a 2 for 1 dining coupon lately? Or, how about an offer for a third night free if you pay for two nights at your favorite getaway? You've seen these offers even if you have not taken the merchants up on them. They represent the dynamics of today's marketplace. Competition is fierce. Businesses have to do more, give more value, if they're going to survive. Think of how this relates to the money you have saved. Money is only a vehicle by which we purchase goods and services. If the same amount of money does more now than in the recent past, as in the examples above, then you have an element of deflation. Now, think of how we generally view investment returns. The higher the absolute return the better, right? For instance, a 14% return is much better than, say, 6%. What if *inflation* was 10% in the 14% example and only 1% in the 6% example? Does your answer change? Most people would say so. Here is the challenge, what if your investments decline by 10%, but you could buy more goods and services with the new lower amount than you could with the higher amount before the decline? Are you better off? This idea takes a bit of getting used to, but this may be the reality over the next decade as the global economy adjusts to overcapacity and cures imbalances that have built up over the years (like high savings rates in Asia and low savings rates

in the West).

Consistent Modest Returns

Look at the following return series for two portfolios:

	Portfolio 1	Portfolio 2
Year 1	20%	15%
Year 2	35%	19%
Year 3	-1%	5%
Year 4	-15%	-2%
Year 5	12%	8%

Assume you own portfolio 2 and some friends of yours own portfolio 1. Now put yourself on the golf course with your friends as they boast in years one and two how well they are doing. You might feel inadequate. You're doing well, but somehow you just question the validity of your or your advisor's approach. Of course, year three passes with just modest returns so nobody is jumping up and down. Silence ensues in year four as the topic is turned to vacations, new work challenges, additions to families, etc.. In year five it seems as though everybody is doing much better with their investments than you are with your investments, opening old wounds. As it turns out, these returns get you to the same place, but with less fanfare and, hopefully, without ulcers. The point is, a more consistent moderate return stream can get you to your goals with less volatility and allow you to sleep more soundly!

Leverage

Very simply, leverage is the borrowing of money to invest or buy additional assets to improve overall returns. It applies to businesses that borrow to grow or invest in their enterprises, it applies to home or rental real estate purchases and it applies to buying financial assets. The basic principal of using leverage is to generate a return larger than the cost of the money you're borrowing (generally the interest rate on a loan). If the result is as expected, then the overall return will be enhanced. An example would be an investor who has $1 and expects to earn 15% over the course of the year. He knows he can borrow money at 10%, so he borrows $1 and now invests the $2 for one year. In one year his investment grows to $2.30. He pays back the loan with interest of $1.10. That leaves him with $1.20. He just enhanced his return by a third from 15% to 20%. However, if the expected return is

not achieved the result can be disastrous. Consider the same chap mentioned above, only his return in a year is -5%. His $2 investment goes to $1.90. He then pays back the loan at $1.10 leaving him with $.80. His original $1.00 has dropped by 20%, amplifying the loss by *4 times*.

Taking time to teach is a critical part of our role here at Clearview Investment Partners, LLC. Any feedback you can give us will allow us to improve future content.

Raymond M. Lombardo, CIMA
Managing Partner