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# Make a Plan and Stick to It

The best way to make money in the long-run is to understand and appreciate the power of time and compounding. Compounding refers to the exponential growth of savings resulting from returns being added to investment principal. In the example below, Period 1 Market Return is $70,000 or 7% on $1,000,000. For Period 2, since both the Period 1 Beginning Investment Balance ($1,000,000) and the Period 1 Market Return ($70,000) are added to arrive at the Period 2 Beginning Investment Balance, a return of $74,900 is earned (7% return on $1,000,000 plus 7% return on $70,000 from Period 1). Now to add an element of reality, on average, one out of every three years the market falls. However, even with a down year every three, the magic of compounding can be seen by comparing the Return on Investment in Period 1 vs. Period 7. Due to compounding, an extra $9,360 is earned simply from holding the investment for seven periods!

| Period | Beginning Investment Balance (A) | Market Return | Return on Investment (B) | Ending Investment Balance (A+B) |
|---|---|---|---|---|
| 1 | $1,000,000 | 7% | $70,000 | $1,070,000 |
| 2 | $1,070,000 | 7% | $74,900 | $1,144,900 |
| 3 | $1,144,900 | -7% | -$80,143 | $1,064,757 |
| 4 | $1,064,757 | 7% | $74,533 | $1,139,290 |
| 5 | $1,139,290 | 7% | $79,750 | $1,219,040 |
| 6 | $1,219,040 | -7% | -$85,333 | $1,133,707 |
| 7 | $1,133,707 | 7% | $79,360 | $1,213,067 |

Too often, however, investors make the crucial mistake of changing advisors or strategies before their investment plans can benefit them. A common reason for this mistake arises when investors fall victim to the noise in the media and their own emotions. To many, it's more important to own the flavour-of-the-day stocks or to trade actively as if gambling at the casino than to focus on investing in strong businesses where they can enjoy a rising stock price and often earn a piece of the corporate profits via dividends. In fact, when examining the relationship between dividend growth and share price, generally as dividends rise, share price follows. This combination should provide investors with the growth and income they'll need throughout their working careers, in retirement and eventually to be bequeathed to their heirs.

## Why long term investments in strong businesses trump active trading

### 1. ***Trading costs are lower***

Active trading takes capital out of your hands that could be used to grow and puts it into the hands of the brokers. Over time, they make money and you don't. While some investors may say the costs of trading are lower than ever, they forget that there are trading costs beyond commissions.



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For example, an investor may only pay 1 cent a share for a trade at their broker but it's actually two cents a share if a stock is bought and then sold. Also, the bid/offer spread, the difference between paying the bid price or the offer price can be as narrow as 1 cent a share or as wide as 25 cents a share.

An investor who buys and sells 1,000 shares in 2 transactions ends up spending $20 on commissions to buy and sell and anywhere from $20 to $500 depending on the bid/offer spread. If an investor trades once a month, that's $40 to $520 a month or $480 to $6,240 a year. That's how the broker makes money.

***2. Taxes are minimized.***

At the risk of sounding obvious, the easiest way to not pay taxes is to not incur them. While avoiding taxes altogether is not an advisable strategy, making investments in strong businesses permits long-term holding periods. This allows the accumulation of unrealized gains and acts to defer the tax liability until a position is closed. Considering that the taxable component of a capital gain, incurred from selling a position, can result in up to 25% of the gain going to the tax authorities, deferring this charge can materially increase the amount of compounding a position experiences.

***3. Dividends compound over time.***

Companies are in the business of earning profits. The companies that can increase profitability and free cash flow (money left over after all the bills are paid) are the ones with the greatest chance of raising its dividend.

CN Rail is an example of a company that, since it went public in the mid-1990s, has successfully created free cash flow every year. Since 1999, the dividend has grown from $0.12 to $1.25 per share, giving it a 15-year average growth rate of 37%.

For CN Rail investors, the company has done what it was supposed to – it was increasingly profitable, raised its income regularly and, as a result, the share price rose. Here's why it's important:

***a) Living off the income in retirement***

Consider an investor who put $1,000,000 into CN Rail shares in 1999. At a $6.34 share price (all amounts are post-split), this would have given the investor 157,729 shares. At a $0.12 annual dividend, this would have provided $18,401 in cash income from the dividends.

Let's then add some caveats:

1. The investor is 65 years of age in 1999 and retires that year.
2. The investor needs $70,000 a year to live on and inflation rises an average 3% a year.
3. This is a taxable account so capital gains and dividend taxes must be paid.



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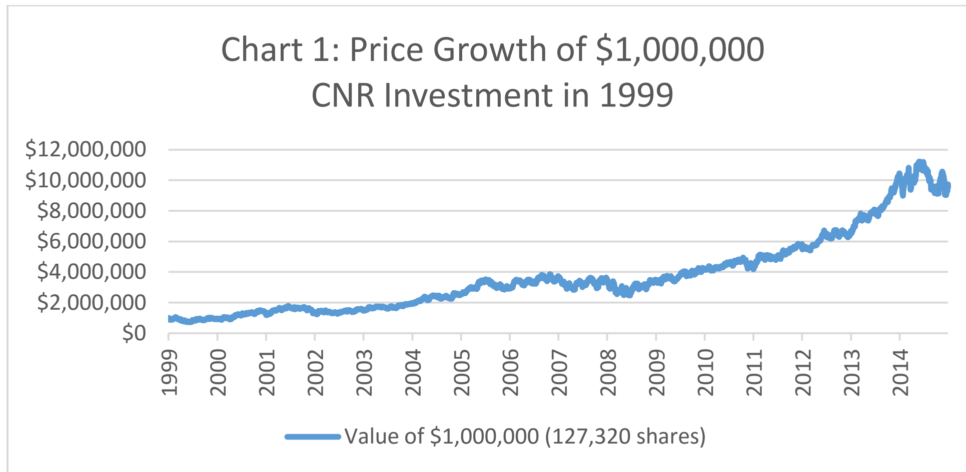
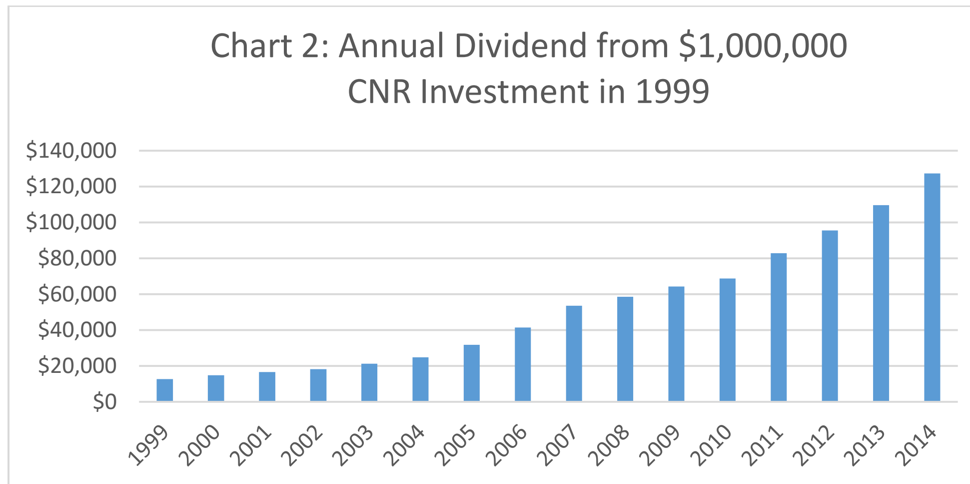
The dividends don't immediately cover the income needs. There's a shortfall of $51,599 ($70,000 - $18,401) at the end of 2000, meaning the investor has to sell some shares to put food on the table.

At the end of 2014, the investor is now 80 years old and has few worries living out the rest of their years. The value of the investment (per Chart 1 below) is just over $9.1 million and the dividend income (Chart 2 below) covers almost all of the living expenses. This leaves most of the capital to continue to compound and grow, leaving a large estate for the heirs.




Source: Bloomberg L.P.




Source: Bloomberg L.P.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### *b) Not all stocks are created equal*

In the above example, CN Rail stock turned out to be a good investment, thanks to the consistent generation of free cash flows and the steadily rising dividend.

However, not all firms may provide a sense of security. Companies that do not pay dividends or those that have to cut their dividend during the holding period may cause investors to run out of money or force them to live a more conservative lifestyle.

This holds true for a number of companies regardless of sector. Using the same parameters and time frame (15 years), companies such as Barrick Gold (resources), Blackberry (technology) and Loblaw (consumer) would have left investors with no capital (Barrick & Blackberry), or a much reduced capital base with many years of retirement to go (Loblaw).

In Loblaw's case, the lesson learned is that it's not just a case of paying dividends; the payouts must continue to grow at a rate that will offset inflation or better. Between 2005 and 2011, Loblaw's dividend remained at $0.84 a share. As its share price fell, an investor would have had to sell more shares and reduce their capital as the dividend income couldn't keep pace with the inflation rate.

### *A cautionary example for those thinking about switching from their 'Plan'*

The danger of switching strategies is the loss of income from the dividend stream (that took years of compounding to build) and the reliance on capital growth in retirement to make it to the finish line.

Say an investor put $1 million into stocks in Year 2000 when the average dividend yield (dividend payment ÷ the stock price) was 2%. The dividend income on the portfolio would be $20,000 (2% of 1,000,000).

Assuming the dividend rose 10% a year, the yield should double every seven years (as '*The Rule of 72*' states, if you divide the rate of return into 72, you will get the time it takes for the position to double e.g. 72 / 10 and you get 7.2 years). By the start of 2015, 14 years would have passed and the initial 2% dividend yield would have doubled to 4% after seven years and doubled again to 8% after seven more years. On the initial $1 million, this 8% yield at cost would annually generate $80,000 in income, an amount that most investors could live off comfortably. This does not begin to take into account any increase in the value of the position.

For argument's sake, let's assume the position doubled between 2000 and 2015 but was then sold and the proceeds were used to purchase different holdings in 2015. In this case the investor would have lost the benefit of 15 years of time and compounding, similar to hitting the reset button.

The investor would have to incur capital gains of $1 million and pay taxes of roughly $250,000. This would leave the portfolio at $1.75 million. Invested at today's dividend yield, which happens



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to be 2%, the income from dividends would drop to $35,000. To maintain the $80,000 income needs, the investor would have to draw down $45,000 from their capital.

A $45,000 draw down doesn't sound like much but the danger is if a big 40% market drop, as we experienced in 2008, occurs. The retirees would run out of money quickly. The $1.75 million fall to $1 million ($1,050,000 minus the $45,000 income shortfall). Divide $1 million by $45,000 and you get just over 22 years.

If the investor is 65, their portfolio would provide funds to live on into their 80s but probably not into their 90s. And if they retired at age 55, they may run out of money before they turn 80. That translates to little or no funds available for inheritance or philanthropy.

**The keys to success**

It's prudent then to appreciate what works and what doesn't in the investment world:

1. Make a plan and stick to it. This allows time and compounding to help you achieve your investment goals.
2. Plan for the long-term and avoid the pitfalls of short-term thinking. This prevents the nickels and dimes from accruing to the brokers or to the tax authorities.
3. Understand that stocks in your portfolio must create consistent, positive free cash flow so they'll still be around in 20 years to help fund your retirement.
4. Before retirement, save, save, save. This will come in handy during years when the market falls.

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