

There is a famous story in investment lore about ambitious young men hoping to get rich. Several young men had just graduated from college in the mid forties. Having seen the hardships of the Great Depression they sought out advice. They wanted to know how to accumulate wealth. They wisely asked the most distinguished and successful investor of the time for a meeting. Surprisingly the gentleman agreed. Realizing their good fortune they diligently researched and prepared several questions expecting a long meeting filled with much advice and many “golden truths”.

On the day of the anointed meeting these young men presented themselves to the great man’s assistant and were shown into the boardroom. They marveled at the oak paneled furniture and luxurious setting. They could barely contain their excitement; they were going to learn the secrets to becoming rich. After what seemed like a very long time a distinguished, grey haired man entered the room and sat at the end of the very long table. One member of the group could not contain his enthusiasm. Much to the embarrassment of his colleagues he blurted out that they were interested in amassing a great fortune just as he had. Without hesitation the investor simply stated: “Never lose.” With those two words he got up and left.

The greatest investor of our time, Warren Buffet, has preached the same message. Mr. Buffett has said: “The first rule of investing is to never lose money; the second and third rules are to never forget the first one.”

It is interesting to note that the most successful long term investors focus on the preservation of capital first and foremost; earning a substantial return is secondary to this primary objective. The reason is rooted in the “principles of investment mathematics”.

In the following paragraphs we explain why “never losing” is so very important. In our view this discussion is significant today as investors are being tempted by unsustainably high equity returns.

Let’s look at two investors Mr. A and Mrs. C. Both individuals have one million dollars. Mr. A is very aggressive. He wants spectacular returns. Mr. A believes what the academics teach; in order to earn a higher rate of return one must take on extra risk.

Mrs. C is very conservative. She wants to preserve her capital. Mrs. C does not have the time to listen to or read academic theory. Of course Mrs. C would like an acceptable return but her primary concern is to feel comfortable knowing that her investment capital is safe.

Mr. A and Mrs. C take very different paths. Mr. A reads about a money manager who has generated twenty plus per cent returns over the last few years investing in resource companies and income trusts. Impressed by these past returns, he eagerly gives his capital to the strong performing manager.

Mrs. C on the other hand is referred to a money manager who is as cautious as she is. He says that he wants to preserve capital; after all his own money is invested along with his clients. Although returns have been modest over the past two years she is comfortable that they share the same philosophy.

For illustrative purposes we will provide two possible outcomes. In the first example, things go very well for Mr. A in the initial two years. However he then suffers two subsequent years of losses. In the second scenario Mr. A losses a substantial amount of capital in his first two years and then earns market returns in years three and four. In both cases Mrs. C earns steady but modest returns.

The tables below illustrate the devastating impact that losing capital has on creating and preserving wealth.

Scenario 1

High Initial Returns and Subsequent Losses

Annual Return	Mr. A.	Annual Return	Mrs. C.
	\$1,000,000		\$1,000,000
20%	1,200,000	4%	1,040,000
20%	1,440,000	4%	1,081,600
(15%)	1,224,000	4%	1,124,864
(20%)	979,200	4%	1,169,859

As you can see from the above calculation, even strong initial returns are eliminated by subsequent losses of capital.

Scenario 2

High Initial Losses and Subsequent Market Returns

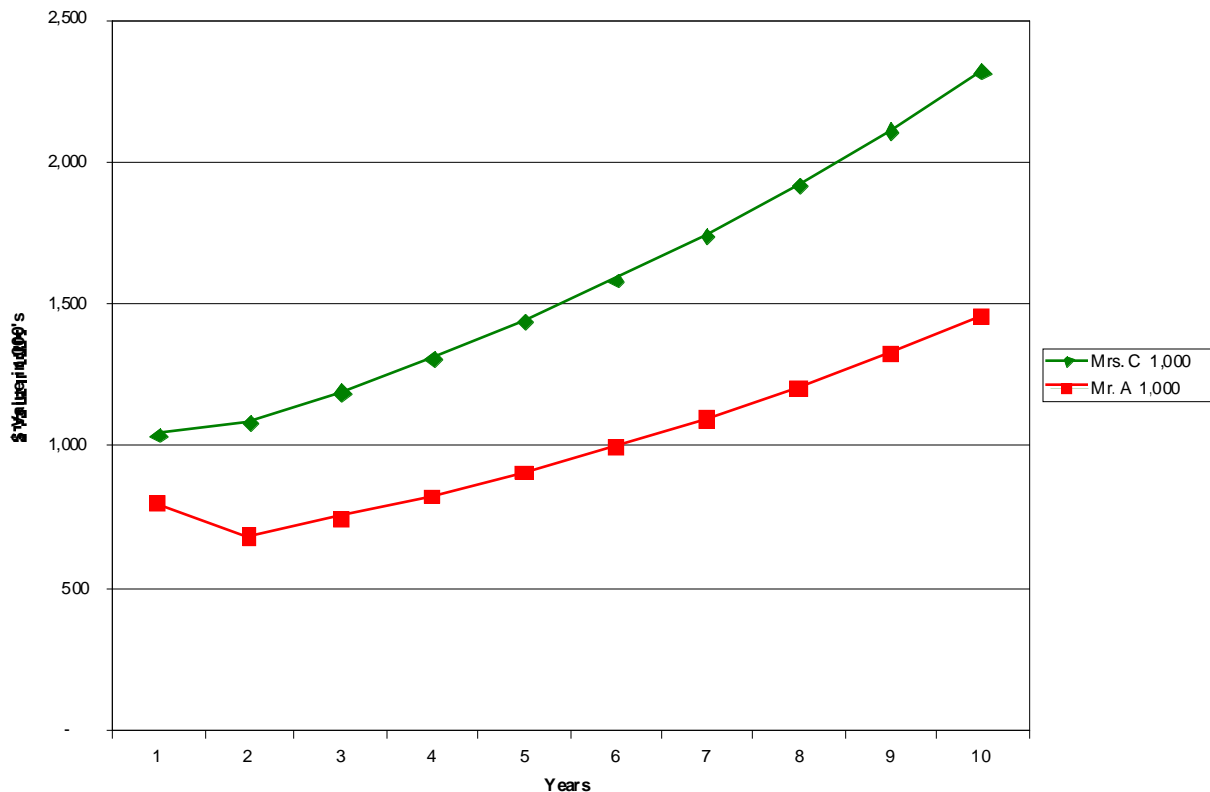
Annual Return	Mr. A.	Annual Return	Mrs. C.
	\$1,000,000		\$1,000,000
(20%)	800,000	4%	1,040,000
(15%)	680,000	4%	1,081,600
10%	748,000	4%	1,124,864
10%	822,800	4%	1,169,859

The example above is a clear illustration of the serious impact that a large initial loss of capital can have on long term wealth accumulation.

If we were to carry out Scenario 2 for another six years Mr. A would still lag Mrs. C by almost \$100,000 despite Mrs. C's low returns! As the graph below illustrates, if Mrs. C

were to earn the same market returns beginning in the third year of the analysis as Mr. A the gap would be insurmountable. After the fourth year Mrs. C would have approximately \$486,000 more than Mr. A. By the tenth year that difference would grow to almost \$861,000!

Graph 1
Wealth Accumulated over Ten Years



The above mathematical principals are similar to the lessons in the popular children’s fable; The Tortoise and the Hare. Slow and steady wins the race.

Never lose! Patient and reliable compounding always generates more wealth over the long term. We at PCM are unwavering in practicing these immutable principals.

Vito Maida, April 2006