The Physician's Guide to Investing

The Physician's Guide to Investing

A Practical Approach to Building Wealth

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Dedication

To my wife Susan, a spectacular lady.

Consulting Editor's Preface

I met Bob Doroghazi when he dropped the first draft of his manuscript of *The Physician's Guide to Investing: A Practical Approach to Building Wealth* at my office. I will have to admit I was a bit skeptical: a physician writing a book on investments? During that first meeting with Bob, it became evident that he had been a successful physician and a successful investor, so I agreed to take a look at the book. I was in for a pleasant surprise. Bob's manuscript was easy to read and had specific advice useful to physicians, interspersed with lots of practical tidbits for any investor.

Having written three college-level finance and investment texts, I was excited to be in on a project aimed at offering practical investment advice to a more general, yet specialized, audience. I had high expectations for the book and am pleased to say that I believe Bob has delivered a book that every physician interested in building wealth and protecting assets should read.

Bob is a straight shooter; he tells it like he sees it in his book. Some doctors might be indignant on reading his statements, such as "Physicians sometimes have no idea of their limitations. This type of arrogance and ego can result in investing disaster." However, if you do have these limitations (and most professionals, even college professors, do), then reading Bob's book will help you recognize situations in which they can lead to poor investment decisions. Bob's advice will help you deal with limitations and point you in the right direction for investing success.

Many of Bob's ideas are in good company and espoused by some of today's most successful investment professionals, such as Peter Lynch and Warren Buffett. Bob does not claim to have discovered these ideas, but he does contribute his own spin and anecdotes for each one. Some of my favorite topics in *The Physician's Guide to Investing: A Practical Approach to Building Wealth* are:

- Don't be the mark.
- Invest in what you know.
- Tips: real opportunities or useless information.
- How to identify real investment opportunities.

In "Investment Strategies of the Pros," Bob discusses some of the traits of three successful professional investors: Peter Lynch, Warren Buffett, and Burton Malkiel. Each have their own special methods. I read Malkiel's *A Random Walk Down Wall Street* when the first edition came out in 1973 as a beginning graduate student. I still have that old copy with its yellow dust cover sitting on my shelf. Next to it are a series of revisions, the latest being 2003. I suggested to Bob that he read and include ideas from Malkiel in his book. To my delight, Bob liked what he read and dedicates a section to some of Malkiel's methods.

The Physician's Guide to Investing: A Practical Approach to Building Wealth is a goldmine of practical advice that anyone can use. Read through the book, pick out what you like, and incorporate those ideas into your own personalized investment strategy. I recognize many successful strategies that I use in my own investments. And yes, I do mow my own lawn.

Dan W. French, **PhD**

Introduction

Physicians are extremely intelligent, hard-working, highly motivated, dedicated, exquisitely trained, and honest, yet they are often poor investors. Even more alarming is the propensity of some physicians to fall prey to investment schemes that can result in a lifetime of debt or even bankruptcy. Why does this occur, and more importantly, what can be done to prevent it?

This book is a commonsense guide to investing, with special emphasis on areas where physicians (and other high-income professionals, such as athletes, artists, performers, and airline pilots) experience difficulty. Considerable time is spent in an effort to generate a sense of healthy skepticism. A good deal of the training of a physician involves trust. We are taught to implicitly trust what our patients and our colleagues tell us. This training is correct. Only by trusting can we create in our patients the trust that they must have in us to act as their advocate, to do what is best for them. In the business and legal world, such unquestioning blind trust is a formula for disaster.

U.S. medical schools produce the best physicians in the world. Yet no time is spent instructing these superbly trained physicians on how to invest the hard-earned fruits of their labor. This is a deficiency of the medical establishment in our country.

I begin by defining goals. What is a reasonable rate of return to anticipate on an investment? What promised rate of return on investment should immediately cause alarm? How do you recognize the real opportunities that do arise from time to time?

Another reason physicians are often poor investors is that the knowledge and confidence in one's abilities that makes an excellent physician can make a terrible investor. Why? Because physicians often feel this tremendous knowledge of medicine (usually a very narrow area of medicine) applies to everything. This feeling of invincibility leads to arrogance, which results in mistakes. Physicians often do not recognize or admit their limitations.

The remainder of *The Physician's Guide to Investing: A Practical Approach to Building Wealth* covers most of the general aspects of investing and financial planning, with the ultimate long-term goal of attaining financial security. There are suggestions regarding your home and the importance of paying the mortgage off early, the magnificence of compound interest, the power of thrift, when to buy an asset and when to sell, and whether you should invest in stocks, bonds, real estate, collectibles, or art. Invest in what you know.

The importance of financial planning is reviewed. Setting financial goals and drawing up appropriate documents, saving for the children's education and your retirement, what type and how much insurance should be purchased, and the importance of minimizing fees are also addressed.

This book is not an exhaustive tome or discourse on investing. Although I have certainly experienced my share of investment failures, I have been successful enough in my personal financial management and investing to have paid my own way through college and medical school, to own my home and vacation condominium free of debt, to have my children's education funded, and to have accumulated sufficient assets so that I will be able to retire at age 54.

This book is not an academic work. It is adequately, but not heavily, referenced. To the contrary, it is meant to be practical and can be easily read in a weekend or on a long trip or plane flight. I would also suggest that spouses read this book.

With few exceptions, this book does not discuss the financial or economic aspects of a physician's practice. This book has nothing to do with the physician as an entrepreneur. Rather, this work is devoted to all aspects of a physician's personal finances and investments.

Physicians make a considerable amount of money. Taking care of sick patients on days, nights, weekends, and holidays is stressful, very hard work. This book provides simple practical advice on how a physician can invest their hard-earned money for a lifetime of financial security.

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Contents

I On Track With Your Financial Goals

Chapter One
Goals for Your Investment Return

I believe that any discussion should begin by defining goals. It is difficult to achieve what you want without having a well-defined goal. Expectations are important. Certainly with something as important as personal finances, one should define their goals and outline precisely how they plan to achieve them. I will thus start by defining what I believe are reasonable investment goals. Subsequent chapters will detail how to achieve these goals.

This chapter has three sections. The first outlines an appropriate minimum return that can be anticipated from investments. The second section details returns that are attainable, but only with hard work and effort. The last section describes returns on investments that are unrealistic, and when promised, should immediately cause concern and alarm. The latter is especially important because it will allow you to quickly recognize the army of promoters and sometimes just plain crooks whose only desire is to separate a physician from their hard-earned money.

YOUR MINIMUM INVESTMENT GOAL

Over the long term, physician investors should anticipate a 10% annual return on investments. Some years this will be greater, some years less, and some years there will even be losses. But over the course of your investing lifetime, actually, your investing lifetime is your entire lifetime, your goal should be a 10% annual return on non-cash investments.

Note I emphasize non-cash. There must always be sufficient cash to cover unexpected needs (more on the importance of cash and cash flow later), debt service, and to take advantage of opportunities. It is the person with cash in hand who can scoop up assets when they are cheap. But the price of cash is that its long-term return is inferior to other investments such as stocks or real estate. In general though, it is preferable to have a little more rather than not quite enough cash.

Ten percent is a round number but I did not choose it at random. Over the course of the twentieth century, stocks in the United States returned an average of just under 10% annually. Slightly more than half of the return, almost 5%, was due to capital appreciation, a number essentially identical to the general growth of corporate profits over this time period.

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Slightly less than half of this return, approximately 4.5%, was from the payout of dividends. However, when inflation is factored in, which decrease the contribution of capital appreciation, the average annual total return from stocks was approximately 7%. Thus dividends actually represented almost two-thirds of the wealth generated by corporations in the United States in the last century. I do not know how any other statistic can better emphasize the importance of dividends. During the stock market bubble of the later half of the last decade it was thought that capital appreciation was all-important and dividends were of no consequence and superfluous. There was a new game in town, we were operating under new rules, a "new paradigm," old rules no longer applied. In the end, old rules always apply, that is why they are old rules. The old rule is that dividends are very important and they count a great deal.

Why are dividends important? Dividends are cash in your pocket, to do with as you see fit. Cash from dividends can pay utility bills, the mortgage, your children's education bills and all the other expenses of daily living. Another reason that dividends matter is that investors believe that the payment of cash dividends is a reflection of a company's financial health. Investors treat a cut in the dividend as negative news about a company's future prospects, such that management will commit to increased dividends only when they are truly confident about their ability to maintain those dividends in the future. Financial analysts call this the "signaling theory of dividends." Simply stated, dividends are a signal about the future prospects for the company. Stable, and especially increasing dividends, are a general indicator of the financial health of a company.

Eventually a company must pay a dividend. If the price of a company's stock increases, but they do not pay a dividend, the only way to recognize this increase in value is to sell the stock. If the company continues not to pay a dividend, the only way the buyer can have cash to pay their daily bills is to sell the stock to someone else, and so on. Early in a company's history, their rapid growth phase, they may retain earnings for expansion, but at some time a dividend must be paid.

Stock prices may fluctuate markedly because of a change in the price-to-earnings (P/E) ratio. Investors are willing to pay more, or less, for what they anticipate will be a stock's price in the future. In the short term variations in P/E ratio are mostly expectations-driven and show a relatively poor correlation with an increase or decrease in corporate earnings. But over the long term, over the course of one's investing lifetime, this variation in price to earnings ratio essentially disappears. In the end, what is left is the true value of the company—as represented by improved earnings—and the dividends that have been paid.

Thus a reasonable long-term goal is an average of ten percent annual rate of return on investments. Considering the average physician's income all that is required to live comfortably and retire when you wish is a little fiscal discipline and the avoidance of stupid mistakes, which is one of the principle points of emphasis of this book. Financial security is important.

A REASONABLE INVESTMENT GOAL

With some work, a little common sense, and knowledge of where mistakes can arise, a 15% annual return on investments may be realized.

I chose 15% for two reasons. The first is that it is attainable. The second reason is that money will double in five years, due to the assistance of your greatest investment friend—compound interest (*see* Chapter Two).

Note this:

Year One $100 × 15% = $115
Year Two $115 × 15% = $132
Year Three $132 × 15% = $152
Year Four $152 × 15% = $174
Year Five $174 × 15% = $201

A little work, compound interest and patience can result in financial security.

A simple way to determine how quickly money doubles is the rule of 72. Divide the rate of return into 72. Money growing at 10% per year doubles in 7.2 years. In the example above, money growing at 15% per year doubles in just under 5 years.

Before concluding this section, I must emphasize that investing is a three-step process.

1. Earn money
2. Do not spend all of the money (for some people this is problematic)
3. Invest the money

For example, one physician saves $10,000 and hits an investment grand slam, realizing a 25% return resulting in $12,500 at the end of the year. Another physician is more thrifty, saves $15,000, and realizes the standard 10% return. At the end of the year this is $16,500. It is virtually impossible for great investing to overcome poor saving habits. The best way to accumulate wealth and attain financial security is consistently save money on a regular basis and invest it wisely. Peter Lynch's says that the number one principle of finance is that savings equals investment. **The best investors are the best savers.**

AN UNREASONABLE INVESTMENT GOAL

Warren Buffett, to my knowledge, has the greatest investment record of the post-World War II era. He has been able to realize almost a 30% annual compound return on his investments. He is a genius, the greatest investor of our time. George Soros (hedge fund director) and Peter Lynch (supervised Fidelity Magellan for many years) were able to generate annual returns nearly as great. They are in the Hall-of-Fame of investing. (*See* Chapter Thirty-Two for an in-depth analysis of the investment styles of Buffett and Lynch and Burton Malkiel).

I am sure there are other investors and groups that have generated similar returns of whom I am not aware, but they are literally one in a million. Of importance as it relates to this discussion is that such people will have bona-fide, verifiable results with reputations and references to match. If you should be lucky enough to find one of these truly gifted legitimate investment wizards, just hitch your star to theirs and hang on for the ride.

The point of this section is that if anyone comes to you saying they will make, almost guarantee, a 25 to 30% or more annual return on an investment, but they do not have a track record to prove it, just tell them to forget it. It is as pure and simple as that. They could conceivably be the next Warren Buffett or George Soros or Peter Lynch (possible, but literally one in a million), but more likely they are bogus and just wish to relieve you of your money.

Here is the essence of what I feel are the difficulties that physicians experience with investing, and which I will detail in the remainder of this book. Physicians do not wish to be left out. They feel their great intellectual gifts, qualities that can result in being the greatest neurosurgeon, cardiologist, or oncologist in the world, automatically apply to areas outside of medicine. The ability to save a life does not necessarily imply the same ability to evaluate a real estate investment or read a financial statement or evaluate the potential of a natural gas property in Wyoming. It just does not.

No one was blessed with greater intellectual gifts than Sir Isaac Newton. In 1687, he published *Principia (Mathematical Principles of Natural Philosophy)* which outlined the basic laws of gravity. Newton developed the calculus (credit also goes to Gottfried Wilhelm von Leibniz for his simultaneous and independent work on the calculus) to provide the mathematical quantification of his theories. Yet Newton lost a great deal of money on the South Sea Company, one of history's most classic investment manias. Newton said "I can calculate the motions of heavenly bodies, but not the madness of people."

Do not worry about being left out. Chances are a million to one that anyone, especially someone you do not know, or have never heard of, who has no previous verifiable results, who tells you, who assures you, who guarantees you a 30% return on your investment, will not. Just forget them. Instruct them to leave and not to come back.

SUMMARY OF CHAPTER ONE

• Reasonable anticipated long-term return on investments	10%
• Return attainable with work and common sense	15%
• Promised, but unattainable, return that should cause alarm	30%

- Dividends are important
- Beware of the "new paradigm." Old rules are important
- The best investors are the best savers.
- Being a physician does not make you smart at everything.

Chapter Two
The Magnificence of Compound Interest

Einstein referred to compound interest as the Eighth Wonder of the World (*see* Table 1 for a list and *see* the first reference at the end of the chapter for an interesting discussion of the Seven Wonders of the Ancient World). How did this scientist, from all of my reading, a somewhat absent-minded individual with no particular investment prowess, come to make this comment, which merits the second chapter in this book and a detailed discussion?

Just examine Einstein's most famous field equation: $E = mc^2$. A tiny amount of mass compounded, compounded, and compounded, again and again and again, results in an unbelievable amount of energy.

A person was once challenged to come up with a saying that applied to everything. The result was "this too shall pass." Why does this comment apply to all situations? Because it describes an absolutely inevitable event—the passage of time.

The economy changes, tax rates increase or decrease, the party in control of the White House or Congress changes, the stock market goes up or down, but the passage of time and compound interest are absolutely inevitable. Compound interest is the physician investor's greatest most powerful tool, their best friend. Compound interest has the same potential power to generate wealth as Einstein's equation does to generate energy. The only requirements are money to invest and patience. Consider this equation:

$$\$ \times \text{CI (compound interest)} = \$\$\$\$\$\$\$\$\$\$\$\$\$\$\$$$

Unfortunately, for one in debt, compound interest possesses the same power to the detriment of the borrower. A home mortgage is compound interest in reverse, and a homebuyer with a 30-year mortgage pays several times the price for the home over the life of the mortgage (*see* Chapter Thirteen).

Examine Table 2 from the book by A. Gary Shilling entitled *Deflation*. Shilling notes that the table is borrowed from Richard Russell of the Dow Theory Newsletter (much more on Richard Russell later).

Each investor puts aside \$2,000 per year, compound at the standard anticipated rate of return of 10%. All interest and dividends are reinvested, and thus recompounded. Investor B puts aside \$2,000 a year for 7 years, from age 19 through 25, and then stops. He never invests another penny (this is just an example, you should never stop investing). Investor A starts at age 26 and invests \$2,000 per year for the next 40 years. Look who wins. Absolutely amazing. Einstein was right.

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Table 1
The Seven Wonders of the Ancient World

The Pyramids of Giza
The Pharos (Lighthouse) of Alexandria
The Temple of Artemis in Ephesus
The Mausoleum at Halicarnassus
The Colossus of Rhodes
The Hanging Gardens of Babylon
The Status of Zeus at Olympia

Table 2
The Power of Compound Interest

Age	Investor A Contribution	Year-end Value	Investor B Contribution	Year-end Value
1–18	$0	$0	$0	$0
19	$0	$0	$2,000	$2,000
20	$0	$0	$2,000	$4,620
21	$0	$0	$2,000	$7,282
22	$0	$0	$2,000	$10,210
23	$0	$0	$2,000	$13,431
24	$0	$0	$2,000	$16,974
25	$0	$0	$2,000	$20,872
26	$2,000	$2,200	$0	$22,959
27	$2,000	$4,620	$0	$25,255
28	$2,000	$7,282	$0	$27,780
29	$2,000	$10,210	$0	$30,558
30	$2,000	$13,431	$0	$33,614
31	$2,000	$16,974	$0	$36,976
32	$2,000	$20,872	$0	$40,673
33	$2,000	$25,159	$0	$44,741
34	$2,000	$29,875	$0	$49,215
35	$2,000	$35,062	$0	$54,136
36	$2,000	$40,769	$0	$59,550
37	$2,000	$47,045	$0	$65,505
38	$2,000	$53,950	$0	$72,055
39	$2,000	$61,545	$0	$79,261
40	$2,000	$69,899	$0	$87,187
41	$2,000	$79,089	$0	$95,905
42	$2,000	$89,198	$0	$105,496
43	$2,000	$100,318	$0	$116,045
44	$2,000	$112,550	$0	$127,650
45	$2,000	$126,005	$0	$140,415
46	$2,000	$140,805	$0	$154,456
47	$2,000	$157,086	$0	$169,902
48	$2,000	$174,995	$0	$186,892
49	$2,000	$157,086 *(sic)*	$0	$169,902 *(sic)*

(continued)

Table 2 *(Continued)*

Age	Investor A Contribution	Year-end Value	Investor B Contribution	Year-end Value
50	$2,000	$216,364	$0	$226,140
51	$2,000	$240,200	$0	$248,754
52	$2,000	$266,420	$0	$273,629
53	$2,000	$295,262	$0	$300,992
54	$2,000	$326,988	$0	$331,091
55	$2,000	$361,887	$0	$364,200
56	$2,000	$400,276	$0	$400,620
57	$2,000	$442,503	$0	$440,682
58	$2,000	$488,953	$0	$484,750
59	$2,000	$540,049	$0	$533,225
60	$2,000	$596,254	$0	$586,548
61	$2,000	$658,079	$0	$645,203
62	$2,000	$726,087	$0	$709,723
63	$2,000	$800,896	$0	$780,695
64	$2,000	$883,185	$0	$858,765
65	$2,000	$973,704	$0	$944,641
Less Total Invested		**($80,000)**		**($14,000)**
Equals Net Earnings		**$893,704**		**$930,641**
Money Grew		**11-fold**		**66-fold**

Reprinted with permission of Richard Russell.

I will give another example of the power of compound interest. Queen Isabella spent $30,000 to finance Columbus. His voyage opened up another world, an amazing investment for humanity. But Warren Buffett suggested that it was a poor investment for Her Majesty. In a letter Buffett wrote at age 32 on "The Joys of Compounding," he suggested that if Queen Isabella had taken the $30,000, invested at 4% compounded annual interest (this is the intrinsic value of money, lent out in a zero inflation environment to a customer who can repay the loan), by the 1960s the Queen's investment would have grown to $2 trillion. Buffett's point is that even (apparently) small amounts of money should be invested with great care because of the amazing potential afforded by compound interest.

The more frequent the compounding of your money the greater the return. For example, on a Certificate of Deposit, the rate of interest may be 4.0%, but because of the quarterly (every 3 months) compounding, the Annual Percentage Rate (APR) is 4.06%. This is the real rate of return. When one is in debt, more frequent compounding has the opposite effect, to the obvious detriment of the borrower.

I have heard physicians make the statement—"you can make investment mistakes when you are young because you can make it up later." This is not correct! In fact, there are several significant problems with this statement.

- It suggests arrogance.
- It presumes that a physician will continue to make a significant amount of money in the future, a possibly faulty assumption.
- It suggests a lack of respect for money, another problem that afflicts some physicians.

- Finally, and most importantly, it ignores the benefits of compounding. It is more financially punishing to make mistakes early as compared to later in life. Profits made and compounded on early successes will more than make up for a bad late-career investment while missed opportunities and bad investment decisions made early in life will NEVER be recovered.

The money will not be made up later. It will never be recouped. Just examine Table 1. You must be more careful, not looser, with money when they are younger. You have less investing experience, and can and will make more mistakes. But as it pertains to this chapter, the younger the investor, the more valuable your money because of the power of compound interest. You must make more than $60 at age 65 for every dollar lost at age 23. Considered from another prospective, the money generated from an hour's work at a minimum wage job at age 23 is more valuable than that generated by a physician working for more than an hour at age 65.

Getting rich quickly sounds neat and glamorous and does occur occasionally. If it happens, consider yourself fortunate. But the desire to get rich quickly is much more likely to result in grief than in the big pay off. The easiest way to accumulate real wealth, your best chance of attaining financial security, is to work hard, save your money, and with the help of compound interest, do it the easy way. Get rich slowly.

SUMMARY OF CHAPTER TWO

- Compound interest is your most valuable investment tool. It is inevitable.
- Even seemingly small amounts of money have amazing potential.
- The younger you are, the more valuable your money.
- Lost money will never be recouped.
- Get rich the easy way. Get rich slowly.

SUGGESTED READING

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II Avoid Being Diverted From Your Financial Goals