MILL STREET & Co.

PERSPECTIVES

No. 001 | May 2016

Lattes, Rainy Day Funds & Wealth Generation

Dear Reader,

Thank you for taking the time to read about our insights through ***Perspectives***. Before you continue reading, I would like to offer a small disclaimer: If you are looking for a broad list of statistics related to investment performance, a slew of research credentials, or a how-to guide of some sort, you will be disappointed. The insights that we present within this paper are not heavily researched, or supported by more than our personal experiences and related observations. Through the process of composing these commentaries, we have learned a great deal about the subject. Our intention is to be successful in adding some measure of value to your own views and hopefully allow you to see the subject a little differently than you did before.

We are always open to feedback and discussion and welcome all questions, comments, or rebuttals. We can be reached by telephone at 905.764.5465 or via email through contact@millstreetco.com.

Noah Murad
CEO

We started Mill Street with the objective of creating real wealth for our investors and the business owners we partner with. Though this may appear to be an obvious goal for an investment company, this type of mindset requires daily focus, discipline and commitment to ensure that we make decisions which will tangibly build wealth. It appears that in most cases well-intentioned strategies, as outlined for us by financial institutions and in the financial media, do not generate wealth in the way we are led to believe.

For the purpose of simplicity, the idea of wealth in this discussion is strictly financial, though when we use the term generally within our organization, the word encompasses many aspects of a fulfilling life (family, friends, hobbies, etc.).

Our "financial only" definition for wealth is owning assets whose yield, whether that yield is paid frequently or just one time, provides a return which replaces significant future labour. In other words, an asset creates wealth for an individual if it saves that person time in the future which they would otherwise have to spend working. To use a practical example, a person who charges by the hour, even if it is $1,000 per hour, is generating wealth if a portion of that $1,000 is; 1) used to acquire an asset; and 2) that the asset's yield is replacing a significant amount of hours which would otherwise be billed. It follows, that growing wealth means proportionately growing control over your own time. To put it another way, wealth grows and operates independently of how much one works. As wealth is generated, work becomes a choice and not an obligation. Work becomes leisure.

Our "financial only" definition for wealth is owning assets whose yield, whether that yield is paid frequently or just one time, provides a return which replaces significant future labour.

When I think about the connection between income (earnings from labour) and generating wealth, my mind wonders to various headlines which I have read in the past, that reference responsible saving in what I call the *Latte Savings Plan* ("LSP"). By not consuming things we don't need – like expensive lattes – the plan says, you can save and be debt free over time. Reduce your expenses to a fraction of your income by not eating in restaurants, taking public transit and walking, buying fewer groceries at discounted prices, etc. If you commit your residual income to paying off your mortgage and other debts, you should be debt free in "X" years. We should simply forgo short term wants for the good of our long term objectives to be debt free. This is a prevailing narrative in the media as the key to financial success and to our freedom.

I am sure that people on the LSP exist, (some are covered in the newspapers as success stories who have paid off their debt), but I am skeptical about how realistic this plan is across a broad range of people and income classes. I suppose as an experiment I could track all of the lattes I didn't buy in a year and then take that cash and put it into a bank account daily to find out the amount. I am fairly sure that even for someone as addicted to coffee as I am could expect to save a few thousand dollars a year. More to the point, my wife and I love having coffee together (expensive and otherwise), and I wouldn't give that up for a few extra years of living debt free. There is a quality of life trade off, which is the essence of why people on the LSP are so few and far between.

There is a good amount of irony in the idea that these people will take on a mortgage, and then live according to the LSP.

There is a good amount of irony in the idea that these people will take on a mortgage, and then live according to the LSP. They don't see value in "overspending" on coffee or restaurants, yet take on a debt that will take decades to repay. And, after the mortgage is repaid, it will take an additional period of time on the LSP to accumulate the money needed to save the same sum which would finally generate "financial freedom" (note that "financial freedom" here does not equal wealth).

As an example, say I save over 15 years and pay off my mortgage of $500,000 at the age of 40. I am not suddenly a multi-millionaire in the conventional sense (i.e. I do not suddenly have assets of $1 million just because my house is paid for). I now have to spend an additional 15 years of labour hours just to accumulate the same $500,000. Even if during the next 15 years I receive a raise, presumably my expenses will increase in proportion because my family will become larger or because my kids are now going to university, etc.

I have asked proponents of this plan why they wouldn't just forgo the home purchase up front by accumulating the money and then buying the home in cash? They would be debt-free for their entire lives. The response I get is usually variations of "the home is an appreciating asset", or "but I want a home today, not in 15 years from now." It turns out that the home is purchased for the same reason why I won't give up coffee with my wife. They want a home today for an improved quality of life now. Taking on a mortgage to buy a home is precisely the opposite of what the LSP claims to be. It is choosing the short term want over the long term objective.

The underlying subtext of the narrative surrounding the LSP and saving in general is that the entire financial goal we should have in life is to own a home debt-free. The mortgage is the largest debt we hold, and presumably, takes the longest to pay off. If this is the case, then it follows that one of the main reasons you are working is to pay down the mortgage. Once you eliminate the mortgage, you have freed your time to do other things, and you are now wealthy. But as the example shows above, paying off the mortgage only resets the dial at zero. A new decade or two of labour hours still need to be completed in order to accumulate the liquidity that would alleviate the obligation of *having* to work.

We create various mental accounts of the cash we hold. $100 found in the street, for some reason is "free money" which we can use for a guilt-free shopping trip. On the other hand, $100 earned from labour is cherished and budgeted carefully.

I use the LSP example because people who subscribe to this idea are presumably saving more than others, forgoing lifestyle, and even they cannot generate wealth this way. The savings, if not properly invested, will likely end up being consumed at one point or another. The reason is not because we are fiscally irresponsible. It is because having perpetual cash savings does not really exist in the way we think it does. Did you ever notice that you create categories for the cash you have? If you find $100 in the street, you tell yourself its "free money." But money you make has to be put aside in some way. Either way, it gets spent.

J.M. Keynes was one of the first people to write about savings on a macro level in the early 1900's. He explained that people hold cash for several reasons, two of which are relevant to this discussion: precautionary and speculative motivations. Precautionary motives would equate to what the media calls having a "rainy day fund", or a "just in case" cash reserve, and speculative motives drive people to invest in liquid asset classes, like bonds (or stocks). The ratio of cash to bonds in the portfolio depends on whether or not you are at that time a "bull" or a "bear" in the market.

In 2008, for example, during the stock market crash, a lot of capital that was originally used to purchase these types of assets were suddenly sold in a frenzy to create cash balances to be used as savings (precautionary). Speculative motives were behind the original investments, when market sentiment was positive. As soon as it turned negative, precautionary motives drove higher cash balances. The ratio of cash to assets changed, but at no point could one accurately call the cash balances "savings" or "investments."

When taken to the level of an individual, one of Keynes' many profound conclusions is that cash, whether it is kept for a rainy day fund, or to be used to purchase liquid assets, will inevitably be either used for consumption or invested. There is nothing in between. Over the long term, all that remains are your investments. Therefore, savings and investments are actually the same thing.

This should explain why many people who are high earners (maybe even in the top 1%-3% of the income bracket) are frustrated in finding that they are not generating wealth.

Imagine that in one year, after taxes, you manage to set aside $10,000. If you had the cash in a savings account for 3 years, and then spent it on a vacation with your spouse, it is no longer savings; it was cash that was used for consumption. Let's now say you save $50,000 over 10 years and unfortunately in year 11, you are let go from your job, causing you to use the $50,000 during the year. Despite the length of time the cash was sitting in a savings account (and what you told yourself the money was for during the time) its ultimate use was consumption, not investment. As it relates to wealth creation, the transient nature of a cash balance does nothing to replace labour hours on a long term basis.

On the flip side, the cash which is used for speculative purposes will usually be lost for different reasons, either because of market volatility, trading and investment advisor fees, or perhaps because it had to be liquidated in order to create the cash needed to supplement the same "rainy day" occasions mentioned above. The point is, and this is the heart of Keynes argument, that the only lasting savings which we truly have are in the form of investments. These investments will usually take form in non-liquid assets, including RRSPs.

With the exception of professions which pay disproportionately large commissions like U.S. banking jobs, executives of extremely large companies who are paid in salaries, large bonuses and stock options, and actors, athletes and musicians, I cannot find the connection between income increases (i.e. raises) and wealth generation. There is a totally separate set of consequences which relate to how this income is invested that connects to wealth. This should explain why many people who are high earners (maybe even in the top 1%-3% of the income bracket) are frustrated in finding that they are not generating wealth. This may also explain why most people who receive raises and advance in their career do not have any more control over their time than they did previously. In fact, many find that their advancements come with added responsibility, while the family is maturing, resulting in less free time, more expenses, and less savings.

The decision made with invested capital is the single most important decision made as it relates to wealth creation.

My point is not that high income, striving for a raise, or saving cash for a rainy day is a useless exercise. Saving for vacations, or for education is very practical and useful. Receiving a raise, or a promotion is an achievement.

The point I am making in this discussion, is that growing wealth directly by increasing income is very unlikely because of the reality of cash management. Cash saved from income is either eventually spent, or if it is invested on a speculative basis in liquid assets, it will likely be converted into cash and be spent.

It follows that the decision made with invested capital is the single most important decision made as it relates to wealth creation. As we have seen, there will not be many opportunities to generate enough residual income to invest. Yet, despite this, we have found that people readily spend their savings, on stocks or other investments which, if they are pressed, can't explain why they invested (at the time it sounded like the right and responsible thing to do). Famous investor Peter Lynch once said in a lecture that if you push people to tell you why they bought a stock, their reason is usually "because the sucker's going up."

One final thought: it is a worthwhile exercise to develop one's own definition of what a "meaningful return on investment" is, as it relates to creating real wealth, without the influence of outsiders. This exercise would involve looking at the end goal, what one wants to achieve for taking the investment risk, and working backwards. In this context, an advisor you just met, or a newspaper, cannot be relevant in telling you how much you should earn from your investments, and therefore, define the wealth you can generate and in what period of time.

An individual taking this exercise seriously would come to the conclusion that the financial return he or she truly wants to achieve is not in any way similar to what these outsiders recommend, or maybe even in some case believe is possible.