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Basics of Finance.

The Rule of 72

It's really not so much a rule as it is a logical formula to measure the performance of your investments. It's just math to determine how long it will take to double your money given a fixed rate of return. By dividing 72 by the interest rate, an investor can get a rough estimate of how long it will take to double the investment. If you earn 7%, you will double your money in 10.3 years (72/7). You can double your money in 7.2 years if you can earn 10% (72/10). If you earn 20% you can double your money in 3.6 years (72/20). If this has you questioning your current returns maybe it's time to consider your options.

There are two things (among others) that can specifically lower investment returns. One thing is transaction costs. Anyone who claims they can outperform the market probably does so irregularly at best. Assuming one can invest like the "DJIA" or the "S&P 500", the cost of doing so alone would pull returns below those "averages" as there is no such thing as a free lunch. The costs due to turnover and transactions will reduce your returns. That's one reason why the industry likes for money to move. And it's helpful to remember that statistics can be designed to make anyone's case.

The second thing that can generally tend to lower investment returns is diversification. One reason some can outperform the market is that they do not diversify. For a humorous analogy of how diversification can lower returns, consider the farmer's wife who wants enough chickens to keep her family in eggs. She can have Rhode Island Reds, or Dominique, or Leghorns. She might even want some Cornish hens or a peacock in the yard. But give her a goose that lays golden eggs and she's going to forget diversification. Diversification helps reduce the risk of having all "eggs in one basket," what is known as single stock risk.

Our publically traded market is a great system. We can be rewarded for participating. One of the things that make the market work is "the scrutiny of many participants". This is a double edge sword as we also can "follow the crowd" right over the cliff. So remember logic rules and statistics can be misleading. The truth will set you free!