

# 7 Rules of Thumb to Investing



Here are a handful of relatively simple principles and formulas that can be particularly useful when growing and managing your savings.

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As the saying goes, money cannot buy happiness, but it can certainly contribute to it. Working as an employee or setting up your own business are the most common ways of earning a living and meeting day-to-day expenses. But a professional occupation should not be seen as the only way to generate income. To quote Warren Buffet: "If your salary is your only source of income, you're one step away from poverty..."

Other sources of income include the beneficial interest of financial investments. Savings and investment offer tremendous advantages, such as the preservation of purchasing power, the possibility of passing on assets to heirs, and the prospect of additional income, particularly in retirement.

When building their investment portfolios, savers have to make trade-offs between risk and return. The riskier the investment, the greater the potential gain, but the greater the risk of losing it all. The ever-changing dynamics of the equity, bond and real estate markets demand time, expertise and in-depth analysis of the investment vehicles considered.

Nevertheless, there are several simple financial rules that investors can follow to set up an investment strategy and avoid the potential pitfalls. Here is an excerpt.

#### Rule #1 —

### The 72 (double), 114 (triple) and 144 (quadruple) Rules

When making decisions about wealth accumulation, it is important not to overlook the importance of compound interest (or performance). Unlike simple interest, which is calculated on the basis of unchanged capital, in the case of compound interest, the sum taken into account for the calculation of interest includes previous interest, i.e., interest accrued in previous years.

Investors tend to underestimate the importance of investing for the long term, especially when the returns on investment seem unattractive. Yet compound interest allows capital to grow even with low returns (or performance).

A simplified formula for estimating how many years it will take for an investment to double its initial value is to divide 72 by the expected annual rate of return.

For instance, at an interest rate of 4%, the amount invested will double in 18 years ( $72/4=18$ ). A figure that should encourage many investors to hold their investments over the long term.

The mathematical formula of the 114 rule is similar to that of the 72 rule and makes it possible to estimate the number of years required to triple one's initial capital. For example, at an interest rate of 4%, the amount invested will triple in 28.5 years ( $114/4=28.5$ ).

The rule of 144 can be used to estimate how many years it will take to quadruple the investment. For example, an investment in a plan growing at 4% a year will quadruple its initial value in 36 years ( $144/4=36$ ).

Although more precise formulas exist, these estimation tools are practical and can be used without a calculator to obtain an approximation. Results are fairly realistic for interest rate levels between 6% and 10%. And they can be used in reverse to calculate the rate of return needed to double, triple or quadruple over a given period.

#### Rule #2 —

### Rule of 70

Inflation diminishes the real value of household savings. But how do you assess the impact of rapidly rising prices on your purchasing power? The Rule of 70 is a simple way of measuring the long-term effect of inflation.

To predict your future purchasing power, divide 70 by the current inflation rate. This allows you to estimate how many years it will be before your investment loses half its current value, assuming a constant inflation rate.

For example, with an inflation rate of 4% (current US inflation rate in July 2023), the real value of your assets will be halved in 17.5 years ( $70/4$ ). This erosion should encourage investors not to remain in cash, to protect the real value of their assets.

However, this rule assumes that the inflation rate is constant and remains at the same level for a long period, which seems unlikely. Moreover, rising prices do not have the same impact on all households. Some consumers may have a personal inflation rate below (or above) the national average, depending on the goods and services they consume.

This method is particularly useful when planning for retirement, bearing in mind that inflation is in fact subject to fluctuations.

#### Rule #3 —

### The Wealth Metric

"Whatever your age, whatever your income, how much should you be worth today?" is the question asked by Thomas J Stanley & William D Danko in 'The Millionaire Next Door', a book that retraces the success stories of self-made American millionaires. After years of surveying high-income and high-wealth individuals, they have developed several formulas for calculating wealth. One of them is for determining whether your wealth level is where it should be today.

The formula is simple: multiply the age by the realized pre-tax income from all sources (excluding inheritance) and divide by 10.

For instance, if a person is 41 years old, earns \$143,000 a year and lives in the United States, he will be considered wealthy if the net value of his current assets exceeds \$586,300 [ $(41 \times 143,000) / 10 = 586,300$ ]. If a person living in the U.S. is 61 years old and has a total realized annual income of \$235,000, the net wealth should be \$1,433,500.

The underlying rationale is that the higher the age and the greater the income, the higher the net worth. The number 10 represents a rule of thumb that applies only to the U.S. market.

Another rule developed by the authors is to determine "whether you are a PAW" (prodigious accumulator of wealth), i.e., the top quartile. To be considered a PAW, a person must possess twice the expected level of wealth. In other words, a 41-year-old earning \$143,000 a year must have more than \$1,172,600 to be considered a PAW.

#### Rule #4 —

### The 10-5-3 Rule

Although there are no absolute promises, this rule estimates the expected annual returns for equities, bonds, and cash over the long term. On average, they should be 10%, 5% and 3% respectively (reference currency: US dollar).

However, this rule is mainly valid for a time horizon of around 15 to 20 years. Furthermore, the 10-5-3 rule does not take into account market volatility factors.

#### Rule #5 —

### The Emergency Fund Rule

As the very name suggests it, it is a wise practice to keep between six months and one year's worth of expenses in an "emergency fund." The expenses considered should include the cost of accommodation and utility expenses (food, transit, insurance, etc.). This amount may seem overwhelming at first, but the point is to set aside a small amount each month to achieve this goal and adjusting it according to obligations related to family needs, job stability and other considerations.

It is best to place the "emergency funds" in an interest-bearing account, such as a money market instrument or savings account, from which liquidity can be easily accessed without incurring penalties or taxes. Segregating this emergency "nest egg" in a dedicated account avoids forced sales of risky assets when you need to withdraw cash.

#### Rule #6 —

### Asset Allocation: the "100 minus age" Rule

The "100 minus age" rule is an approach for determining the strategic allocation of your investment portfolio.

In other words, it involves determining how much of the portfolio should be invested in equities and how much in bonds. The proportion to be invested in equities is the result of deducting the age from 100, with the remaining amount invested in bonds.

For example, if a 25-year-old wishes to invest \$1,000 per month, according to the 100 minus age rule, the percentage to be allocated to equities would be  $100 - 25 = 75\%$ . Thus, \$750 should be invested in equities and \$250 in bonds. Similarly, if a 60-year-old wishes to invest \$10,000 per month, the fraction allocated to equities would be  $100 - 60 = 40\%$ . This would mean investing \$4,000 in equities and \$6,000 in bonds.

This rule reflects the logic of a higher allocation to equities when the saver is at the beginning of his working life, and a lower allocation when the individual is approaching retirement. Indeed, in the event of a sharp fall in the equity markets, a young investor will have the opportunity to recover his losses in the next income stream and/or in future bull markets. In contrast, an investor close to retirement may suffer a stock market crash at the worst time of his life, i.e., when he needs part of his assets to compensate for the imminent disappearance of his work-related income.

#### Rule #7 —

### The "Pay Yourself First" Rule

Most people entering working life consider savings to be their last priority. And yet, building up savings early in one's career can have a major impact on the capital available at retirement.

According to experts, the optimum is to save 10% of your current salary. Let's take the following example: a person starts working at the age of 25, earns \$5'000 monthly and saves 10% of his salary every month over a 20-year period. Assuming that his salary grows by an average of 10% a year, and that the fund in which the savings are invested performs at an annualized rate of 8%, the capital available at age 45 will be \$642,379.

In addition, it is recommended to increase the savings percentage each year, taking into account additional expenses and the inflation rate.

## Conclusion

The above rules are simple, practical, and relatively accurate. They are based primarily on experience and practice, rather than theory. These rules do not have to be applied in the absolute sense of the term, but they can often serve as a guide for savers, particularly when it comes to setting up a long-term investment strategy or asset allocation.

## For further information

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