CHAPTER 5

The Edge™: Don't Bet Against the House

You now know how the robber barons used the banking and monetary system to their advantage to control stock prices and to attain great wealth. However, you are probably wondering how this is going to put *you* on the road to financial freedom and true wealth. I am happy to tell you that, while you obviously do not have the ability to control the banks, you *do* have the ability to watch what they do, anticipate the results, and invest accordingly.

But first, let us talk about what *not* to do.

A Brief Review of Conventional Investing Wisdom

Conventional investing wisdom says that the best way to achieve wealth is to invest in a diversified portfolio of large stocks, often through a well-managed mutual fund, and then to wait. This technique is sometimes called *buy and hold.* If you invest in a mutual fund that tracks the most common large-cap stock index, the S&P 500, you would probably get around a 10 percent annual return on your money.

Over an extended period of time, this can definitely create wealth, as Table 5.1 illustrates.

This is pretty amazing when you consider that someone with as little as $10,000 can become a millionaire over

Table 5.1 The Power of Compounding

Time Period	Value of an Initial $10,000 Investment
5 years	$16,105
10 years	$25,937
25 years	$108,347
35 years	$281,024
50 years	$1,173,909
75 years	$12,718,954

a long enough time. This means that a student who works and saves during high school and puts all his money into this buy-and-hold strategy would be a millionaire by retirement. Alternatively, if you put the money into this strategy upon your children's birth, they can become millionaires by their retirement.

The Problem with Buy and Hold

Before you put all your money into the S&P 500, you may want to consider a couple of things:

- This strategy can be extremely volatile over shorter periods of time, particularly if you start investing at the beginning of a bear market for large stocks. This means enduring an incredible amount of pain and stress until the strategy starts working. Not everyone has the stomach for this.
- Many people do not begin to prepare for their retirement until they reach their 30s. They do not have 50 years to let the strategy work.

One possible solution to this is to put additional funds into your investment program. This is a great idea, which I totally support and encourage. Try to save the maximum amount that you can. However, there are factors that limit the amount by which we can reduce our daily expenses, such as health issues and education for your children.

The Potential Solution: The Edge

If you cannot add additional money to your investment program, then, the conventional wisdom of *buy and hold* may not lead you to the financial independence that you always envisioned. What is the solution?

The solution is The Edge™.

What is The Edge? *The Edge* is a small increase in the return on your investment that allows you to reach your financial goals much faster. We are not talking about a get-rich-quick scheme. We are talking about minor increases in returns that can make big differences in your wealth.

Let me illustrate my point by showing you the value of an initial $10,000 investment at different rates of interest over time (Table 5.2). The interesting thing about this table is the power of time. As the time horizon lengthens, the power of small increases in the rate of return is incredible! This is why Einstein once referred to the power of compound interest as "the eighth wonder of the world."

In order for The Edge to work, you have to have a longer time horizon. Let us examine a 10 percent and a 20 percent rate of return at 10-year and 25-year time horizons. Using a 10-year time horizon, the difference between the ending values of a $10,000 investment is $25,937 versus $61,917, more than double your money. However, at a 25-year time horizon, the difference is $108,347 versus $953,962, almost ten times your money. This difference increases even more as we lengthen the time horizon further.

Table 5.2 Compounding with Higher Returns

Time Period	10%	13%	16%	20%
5 years	$16,105	$18,424	$21,003	$24,883
10 years	$25,937	$33,946	$44,114	$61,917
25 years	$108,347	$212,305	$408,742	$953,962
35 years	$281,024	$720,685	$1,803,141	$5,906,682
50 years	$1,173,909	$4,507,359	$16,707,038	$91,004,382
75 years	$12,718,954	$95,693,681	$682,887,545	$8,681,473,693

Getting The Edge: A Trip to the Casino

In order to understand the tremendous power of The Edge in equity investing, let us take a visit to a Las Vegas gambling casino. Here we examine the various characters and their counterparts in the investing world.

The Average Player

You know this guy, the one who gets off the bus expecting to make a killing at the casino but has no clue what he is doing. Casino management will pay a premium to get average players into the casino in the form of free drinks, complimentary meals, hotel rooms, and shows because they know it is only a matter of time before they get their money back (and much more). Despite the freebies, this will be an incredibly expensive vacation. Average players often play the games with the worst odds, such as the slot machines.

This is typical of the average participant in the stock market. He has no idea what he is doing. He generally has no strategy and, even if he has a strategy, like buy and hold, he is unable to stick to it. Thus, his return in the long-term does not equal the return of the S&P 500. He is a loser, just like in the casino.

The Gambler

This guy is a smooth operator. He focuses only on games where the odds favoring the house are limited. Gamblers may be card players and often try to change the rules in their favor. Gamblers are disciplined, which is what prevents disaster. Gamblers make a living but never are able to get truly wealthy because it is very difficult to change the odds.

This is the S&P 500 index investor that we discussed earlier. These investors make money and do well if they are truly disciplined and can stay in it for the long term. However, index investors must have nerves of steel.

The Player on a Winning Streak

You have seen this guy before. He is at the craps table with a crowd of new-found friends around him, including the pretty girl throwing the dice for him. He is having the time of his life—the center of attention and the life of the party. Everyone on the casino staff is giving him the deference and courtesy due a high roller. This guy is on top of the world. There is only one problem: Players do not know how to quit while they are ahead. That is why the casino staff treats them so well. They know that if they encourage Players to believe that this is skill, not just luck, they will continue to gamble until eventually they give all the money back. If it does not happen today, it will happen before the end of the trip. Players should not be mistaken for Gamblers. They have no system or discipline.

In the stock market, most traders, especially day traders, fit neatly into this category. There are some who may fit the category of the Gambler, but, in general, they mistake luck for skill. Instead of knowing when to quit, they continue until they lose. If they have backers, they drag them down with them. The odds are stacked against them, something they will eventually find out—the hard way.

The Underworld

The *Underworld* refers to the underground gambling establishments, bookmakers, and other assorted shady characters that inhabit the gambling world outside the legitimate casinos. These individuals already have their hands on your money the day that you start dealing with them. They make many outrageous promises to get you involved because once this happens, they own you.

In the world of investing, these are the get-rich-quick schemes that promise to turn $1,000 into $1,000,000 overnight, not over time. They play on your worst emotion—greed. Sadly, many who buy into this are those who can least afford to lose their money.

The Card Counter

The card counter is the one that the casino truly fears. This person has a system that can turn the odds in his favor. Therefore, given sufficient time, he can beat the house, sometimes for truly large amounts of money. Card counters usually have a mathematical background, an extremely high IQ, and incredible discipline and tenacity. They can make a tremendous amount of money for their backers.

The only problem with card counters is there are very few really good ones. The casino is always trying to shut them down. If it finds out that someone is counting cards, that person is banned from the casino. Thus, card counters employ disguises, deceptions, and other ploys to escape detection. It is a difficult way to make money, the reason why there are so few of them. Several write best-selling books detailing their adventures after being banned from the casinos.

In investing, these are the true Wall Street wizards. These are people like Warren Buffett, Paul Tudor Jones, and a handful of other great legendary traders and investors. There are so few of them because of the skill and temperament required to practice their craft. Many people claim that they belong to this class of investors, but most do not qualify and are merely traders on a winning streak. They eventually reach the end of the line and burn out, taking their partners with them.

The problem with these investors is that when they become large and successful, they find it extremely difficult to practice their craft undetected. The market takes away their edge. If you can find a true investing wizard early in his or her career, you have a good chance to make a great deal of money. The Buffett millionaires are an excellent example. These people were fortunate enough to invest in Berkshire Hathaway, Warren Buffett's investment vehicle, early in his career. By investing small amounts of money, they were able to become multimillionaires over the years.

However, it is not easy finding this rare breed. Even if you do, your timing has to be right. If both of these things fall into place for you, remember not to tell anyone. You do not want to accelerate the process of losing their edge.

The Gaming and Local Authorities

The gaming and local authorities regulate and tax the casino. They take a piece of everything the casino makes in the form of taxes, including their restaurants, hotels, nightclubs, golf, and other recreational activities. They do not really care who wins or loses, since they make money either way. All they want you to do is to keep gambling. They entice you with great slogans, like "What happens in Vegas stays in Vegas." They fail to mention that one of the things that stays in Vegas is your money.

Their counterpart in the investing world is—you guessed it—the Wall Street establishment. These are the majority of brokers, advisors, investment bankers, and other assorted characters. They do not care whether you make money or lose it as long as the fees and commissions continue to roll in to pay the bonuses that finance the Wall Street lifestyle and pay for those huge McMansions in Greenwich or the Hamptons.

Do not get me wrong, I know many investment professionals who do truly have their clients' best interests at heart. However, they are few and far between. If you happen to find one, treat him or her like a valuable treasure.

And Finally, the House

In gambling, the casino is called the House. It sponsors the games and sets the odds. Like any other business, its goal is to make money. How does it do this? By setting the odds in its own favor, naturally. In many cases, the tilt in its favor is not dramatic. It is just enough so that over time it will always make money. If the odds were stacked too heavily in the House's favor, the players might go elsewhere.

Over time, the House will always make money because of these odds, despite the short-term successes of the characters described. The laws of probability guarantee it. Steve Wynn, the impresario who built a huge casino empire after a short but unsuccessful gambling career, once said that the only true way to make it in Vegas is to own the casino.

In the investing world, the banking authority is the House. It sets the odds and determines investing success or failure. In the nineteenth century, it was the robber barons, who always stacked the odds in their favor. In the twentieth century, these immense powers were transferred to the U.S. Federal Reserve and the other central banks. The Fed is truly the House.

Don't Bet Against the House: Get The Edge and Follow the Fed

If you want to be a winner in a gambling casino, the answer is to bet *with* the House, not *against* it, as Steve Wynn suggested. I am not suggesting going out and buying casino stocks. Remember, you may not be getting the same deal as Wynn and the other insiders. However, if you could bet with the House under the same terms as the insiders, *that* would be an extremely attractive proposition, something very few people would refuse.

If you can invest with the odds in your favor like the original robber barons you would have The Edge that we discussed earlier. The incremental higher returns generated by slightly higher odds in your favor would not need to be much to get you to the financial independence and true wealth that you desire (as illustrated in Table 5.2). Following the Fed is the true way to get The Edge you want.

By Following the Fed, time becomes your friend, not your enemy. You have a system that works over time and where the odds are stacked in your favor. Thus, you can afford to wait out those periods where things are going against you because you know that eventually, things will turn around.

For those who try the other paths listed here, such as the Card Counter, I wish you the best of luck. However, remember the sage bit of advice for the novice poker player. If after entering a poker game you cannot figure out who the sucker is, it is probably you.