CHAPTER 1

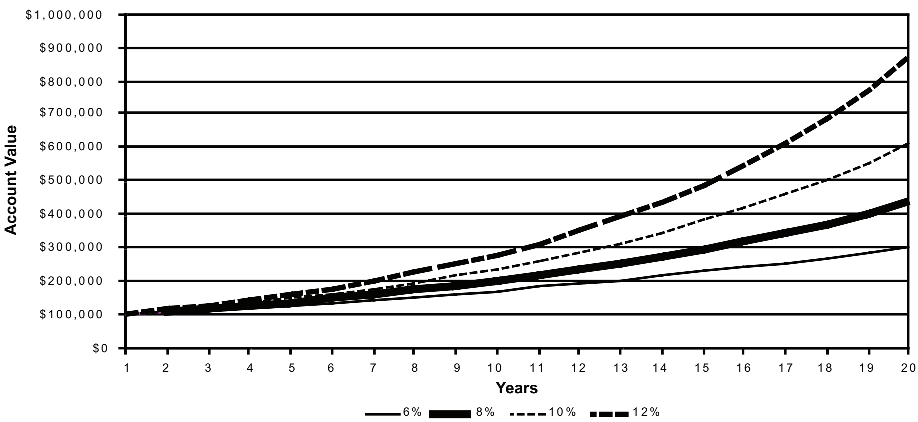
The Importance and Power of Compounding

Why should you bother to push for greater profits with a more active investing and trading program? Historically speaking, equities are already the best asset class when it comes to providing returns over time. Why not just put money in an index fund and sit back? For many with a very long time horizon and no inclination to be involved in portfolio management, a passive index fund approach is perfectly suitable. However, those who have pools of money with a less than "buy and hold forever" time horizon and the temporal resources, as well as the ability and, most important, the desire, can tap into the superior returns that an active trading program can provide. Look at the difference in seemingly small return variations over time shown by Figure 1.1 on the following page.

Two accounts each starting with $100,000 will have dramatically different balances twenty or even ten years later with one account earning a seemingly small three or four additional percentage points per year. This is the power of compounding at work. Incremental differences that would not get your attention in the near term can mean the difference between having to extend your working years and retiring early with security.

Between 1999 and 2009 stocks went approximately nowhere. There were many ups and downs along the way (volatility that you can take advantage of in a profitable way), but a buy-and-hold strategy would have left your brokerage account essentially flat, especially when you factor in inflation. By definition, if you buy the market (and, truth be told, a few mutual-fund holdings are usually a costly way to do just that), your returns will be, at best, slightly south of the market after associated costs. Many smart investors, Warren Buffett among them, believe that the next decade might see returns in the 5% to 8% range, which, after inflation and taxes, will make it hard for many to reach their financial goals. Thus adding even a small level of intelligent trading can get you up the return curve, which, over the years, can make a material impact on the size of your account. Among the four major sources of stock-related gains—long-term capital appreciation (which was viewed as the primary if not sole source of profits in the 1990s), dividends, short-term trading, and income from the sale of options—the latter three sources will likely represent the vast majority of attainable gains in the years to come. My goal is to show you how to make the most of the market's natural fluctuations and to profit from the magic of compounding.

Figure 1.1 **Return Variations over Time**

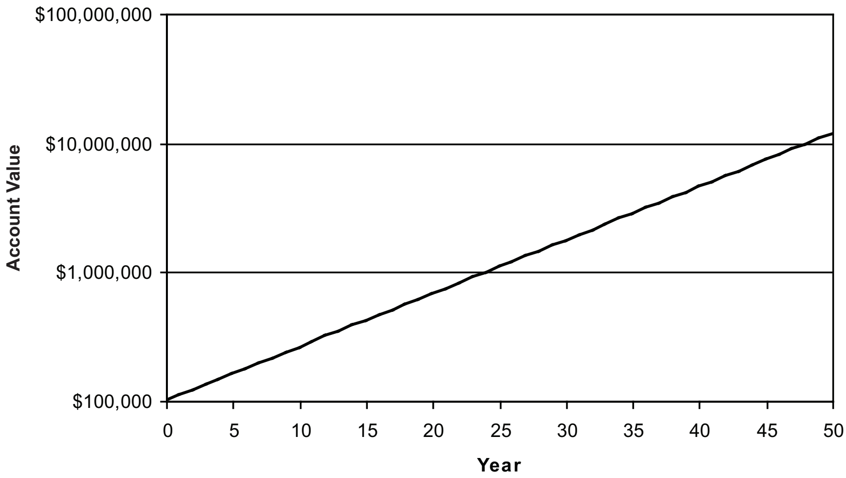


"Compounding Is the Most Powerful Force in the Universe."

Certainly one of the world's great investors had to have uttered this weighty and telling quote. Was it the wise and venerable Warren Buffett? Perhaps the irascible but entertaining Jim Cramer? The legendary and honored Ben Graham? Actually, it was not an investor at all, but a scientist, a particularly famous and important one at that. The man who proclaimed that compounding was more powerful than gravity, electromagnetism, or even atomic friction was none other than Albert Einstein.

Let's look at this force in action.

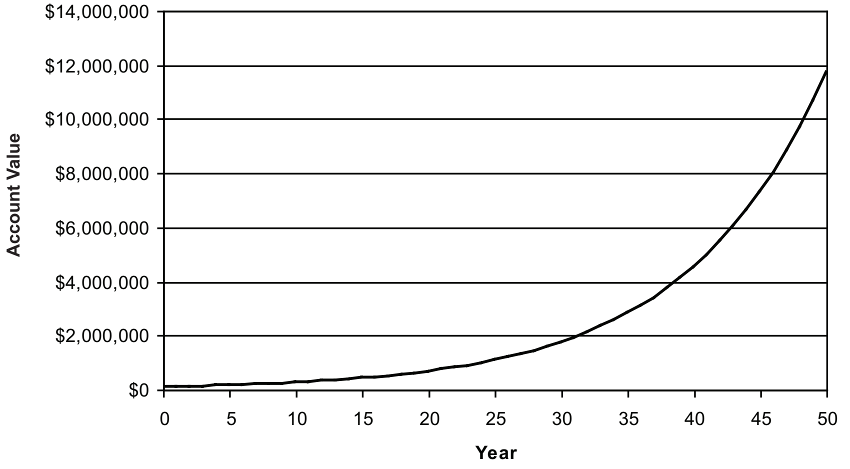
Figure 1.2 **Logarithmic Representation of Compounding**



In this representation the vertical axis is skewed so that a given distance always represents the same percentage change. (This means that the distance between 10 and 100 is the same as between 100 and 1,000 since each represents a tenfold growth, although the absolute gains of going from 100 to 1,000 are clearly greater.) You will occasionally see stock-gain charts that use this methodology. Do not be fooled! The real gains (since we are focused on absolute gains) are shown by Figure 1.3 on the following page.

As you can see from the figure, the power of compounding kicks in as time goes on. Investment gains (annual percentage returns) may appear at first glance to improve over time since the chart seems to be flat in the early years and to go higher in later years. In reality, it is the magic of compounding "doing its thing" in subsequent years that makes these gains so large on an absolute basis.

Figure 1.3 **Linear Representation of Compounding**

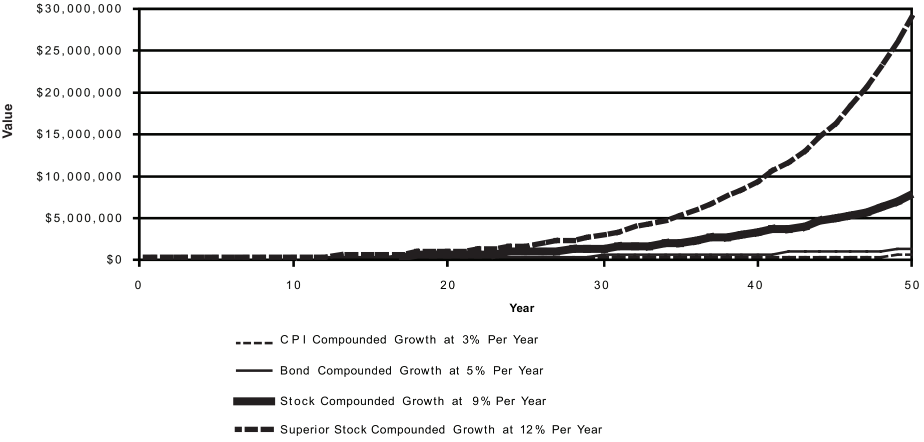


Let's do some basic math. Your account starts out at $100,000. In the first year you make 10%, or $10,000. Now your account is worth $110,000. In Year Two you make another 10%, bringing your total account value up to $121,000. (You made 10% not only on the original $100,000 but also on the $10,000 from Year One, yielding total Year Two profits of $11,000.) In Year Three you make another 10%, in this case $12,100, and so on. By the end of Year Ten your account is up to $259,374; by the end of Year Twenty your account is worth $672,750. By Year Twenty-Six, the amount of gains *per year* exceeds the original investment amount. The power of compounding has taken hold.

Few people appreciate that even small differences in returns can have a dramatic impact on account balances over time as compounding works its mathematical magic. Let's examine four basic return scenarios: inflation as defined by the Consumer Price Index, the thirty-year bond, approximate average historical equities, and what could be classified as superior stock gains.

As you can see from Figure 1.4 on the following page, seemingly small variances in annual returns—a few percentage points—can have a meaningful impact on account balances over time. Just a few percentage points of improvement in annualized returns (from 9% to 12%, for example) can mean the difference between taking a cruise and owning a yacht.

Figure 1.4 **The Impact of Differing Annual Returns**



Now that we know how the power of compounding aids in wealth creation, let's see how we can best tap into this force in the equities and **options** markets.