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For the Intelligent Investor
Answers to questions you may not even know you have.

Fund Your IRA Every Year, or How to Retire Wealthy by Driving Used Cars

This essay was originally published in Muhlenkamp Memorandum *Issue 34, April 1995.*

Recently, I commented to a friend that most investors buy stocks the way teenagers buy clothes. He responded, "How should they buy stocks?" Being a slow thinker, I didn't have a ready answer then, but I do now. Buy stocks the way you would buy used cars. The truly amazing fact is, if you also buy used cars, you can get rich on these two actions alone.

It is not hard to save $2,000 per year by driving a used car. Figure 6.14 shows that by investing $2,000 in an IRA every year, you can accumulate $1 million (at 12%) in 36 years or $928,000 (at 10%) in 40 years.[1]

Figure 6.14 $2,000 per Year Compounded at 10% and 12%

YEAR	10%	12%
5	$ 12,210	$ 12,706
10	31,875	35,097
15	63,545	74,559
20	114,550	144,105
25	196,694	266,668
30	328,988	482,665
35	542,049	863,327
40	885,185	1,534,183

[1] Beginning in 2005, the allowance for IRA contributions is $4,000, along with a catch-up contribution of $500 for people 50 years old and older. In 2006, the catch-up contribution amount was increased to $1,000.

Muhlenkamp & Company, Inc.
Intelligent Investment Management
5000 Stonewood Drive, Suite 300 • Wexford, PA 15090 • (877) 935-5520 • www.muhlenkamp.com

There are three keys to saving $2,000 per year by driving a used car:

1. Insure only for liability. This alone will save you more than $600 per year.
2. Do not pay interest, which would cost you at least $130 annually per $1,000 borrowed.
3. Buy only what you can pay for in cash.

Do Your Homework

So how do you buy a *good* used car, or a *good* stock? In each case, start at your local library. There you will find books titled *How to Buy a Used Car* (or something similar), which can be read in a few hours. Read one of them. It will give you criteria to use and a framework to work from.

For stocks, you need to be a little more careful. The principal difference between buying used cars and buying stocks is that, with stocks, many more of the charlatans write books. Be sure the author has a successful history of making money by investing, not just by selling books or magazine articles. These authors will also give you criteria to use and a framework from which to work. Peter Lynch's *One Up on Wall Street* is among the best I have found. Beyond that, read Ben Graham, Irving Fisher, and Warren Buffett. (Do not confuse the recent best seller *about* Buffett with the writings *by* Buffett.) Jim Roger's *Investment Biker* is a must for anyone considering foreign investing. It also provides an interesting perspective for those who are not.

When shopping for cars, your next step is to check out the data in *Consumer Reports*. Their data is based on consumer surveys and is so organized that in 20–30 minutes you can rule out the 80% of cars you do not want to own and focus on the 10%–20% that you might want to own. If you want to refine the *Consumer Reports* data, talk to your mechanic, (or as my neighbor did, to your tow-truck driver). If you do not yet have a mechanic you respect and trust, ask your neighbors with an interest in cars whom they trust. Do not be afraid to ask several neighbors. I have never met a person who resented being asked for advice, and just because you get several opinions does not mean you have to follow all of them.

When shopping for stocks, I begin with *The Value Line Investment Survey*, looking for companies with good balance sheets and a good return on equity capital (ROE). The ROE should be 15% or better; an ROE of 10% or less is not worth their being in business. I don't like to state rules of thumb because they are subject to change with inflation and interest rates, but today I would like the price-to-earnings ratio (P/E) to be less than the ROE and the expected growth rate. Next, call the company to get their financial statements. Check the numbers and the footnotes in the annual report (it is audited) to be sure the *Value Line* numbers are accurate.

At this point, you will have identified up to a half-dozen car models that satisfy your criteria. Now it's time to shop the newspaper, because you would like to buy from a private individual. You would rather avoid a dealer because dealers dress up the cars they sell and know how to disguise problems. But the main reason you want to buy privately is because you would like to judge the current owner as well as the car. The degree of care the car has received can enhance or negate the record that you got from *Consumer Reports*. There are no used cars I would buy sight unseen, but there are people (very few) whose used cars I would buy sight unseen. In such cases, I would be buying based on my knowledge of the owner. Once you have identified a model that fits your criteria and a car that appears to be in good shape, be willing to pay your mechanic to check it over (it is cheap insurance).

Similarly with stocks, you would like to talk to the management of the companies you are interested in buying. For the individual, this is not always practical, but you can often get a reading on management from the company's annual report. The letter to shareholders should give you a summary of what management sees in their markets and what they are trying to accomplish. The best management will spell out the company's goals in specific terms. The proxy material will tell you how much stock management owns and whether they are compensated in ways that encourage them to work for the shareholders. In nearly all cases, the quality of the company's management is more important than the characteristics of the industry they are in. Finally, check with the company's customers. If the customers are happy, the company is doing something right.

The Winners, the Losers, and the In-Between

With both used cars and company stocks, you will find that junk is junk; there are many models and many companies you do not want to own at any price—so don't! Good is good; you will find some that you would like to own at a fair price. And there are a few gems that are worth paying a premium. (Warren Buffett has suggested that you should expect to find fewer than 20 gems in a stock-picking lifetime.) With both cars and stocks, look for the gems, but expect to compromise, particularly on the nonessentials. If you accept only perfect gems, you will miss a lot of good stocks and do a lot of walking.

Finally, be aware that no matter how much effort you put into it, on occasion you will get a lemon. When this happens, sell it and go on to the next vehicle. Selling a lemon may be a blow to your ego, but it's a lot less painful than keeping it. You will find that commissions for selling a stock are low. You will also find that selling a lemon you paid $3,000 for is a lot less painful than the new lemon your neighbor bought for $20,000.

How long will all this take? My daughter-in-law knows nothing about the mechanics of cars and knew nothing about shopping for them. Using the above advice, she spent four hours in the library and five or six hours shopping. In the end, she bought a good used car for $4,500. On stocks, I spend 40-plus hours per week.

The Road We've Traveled

Out of curiosity, I decided to check my own record. In 32 years, I have bought and sold 24 cars. The total of the purchase prices minus the sales prices is less than $20,000. If you adjusted this for inflation, it might be $30,000. So, our annual depreciation cost has been less than $1,000, and we've been a two-car family since 1970. Today, a more realistic depreciation would be $1,000 per car per year.

In the meantime, I have been fully funding my IRA since the law became effective in 1981. I have contributed $29,500 (in 1981, you could only contribute $1,500). I have not done anything fancy or heroic, just put the money in two good no-load, total-return mutual funds. As of March 31 of this year (1995), the market value was more than $76,000. A glance at Figure 6.14 shows that it has been compounding at better than 12% per year, and I am on track for a prosperous retirement.

We've seen some articles making the case that not everyone should fund their IRAs. We agree. The value of a traditional IRA or other tax-deferred asset is that the taxes are deferred. The negative is that when the assets are drawn out to be spent, they are taxed at the rates applicable to ordinary income, even if the returns were earned through capital appreciation. This has the effect of converting capital gains to ordinary income, so when your tax-deferred assets reach a level resulting in withdrawals being taxed at a rate over 30%, we believe it longer makes sense to fund them. As a rule of thumb, when you become confident that your tax-deferred assets (pension plan, profit sharing plan, and IRA) will exceed $1 million by the time you reach 60, it makes sense to cease funding your IRA (and to take a full measure of comfort in what you have accomplished).

2007 Update

In line with the last paragraph, I have not contributed to my IRA since 1995. As of December 31, 2006, the market value was more than $340,000. A glance at the table shows that it has been compounding at better than 12% per year, and I remain on track for a prosperous retirement.