Jeff Speakes
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How to become a Billionaire
By Bill Ackman

Hedge fund manager Bill Ackman has produced an interesting lecture on finance and investing. It can be found at www.floatinguniversity.com. It is one of twelve lectures on "big ideas" currently residing on the site.

Ackman's lecture, titled "All you need to know about finance and investing in less than one hour" and subtitled "How to become a billionaire," begins with the business plan for a lemonade stand and includes formation of the company, initial capitalization and a set of five-year pro forma financial statements. The first year plan with one lemonade stand is discouraging, with 1% pre-tax margins and negative net income. However, based on assumptions of increasing unit sales and price per cup and expansion to seven lemonade stands, the five-year outlook is terrific. Year five profit is 100% of the equity investor's initial outlay, and growth prospects are amazing. In fact, if you push the scenario out another ten years, based on Ackman's assumptions, this lemonade business would be the most profitable business in the history of mankind.

The driving force behind the impressive projection is huge productivity growth; Ackman's assumptions imply about ten percent greater sales per year per stand with the same inputs. Naturally, such a dynamic will generate phenomenal results. Ackman's point is to show how financial statements work together, how to put together a business plan, and how to measure business performance. His lecture may be used by budding entrepreneurs to build a presentation for investors.

But his greater message is that value investing is a credible strategy for individual investors. Whereas the rate of return in the lemonade stand business is spectacular, Ackman argues that you don't have to achieve such extraordinary returns in order to become wealthy, nor do you need to take the tremendous risks inherent in running a start up business. Instead, you can do very well investing in large established companies. He offers two main rules: first, start early and second, don't lose money.

Start Early

Albert Einstein is reputed to have said that compounding is the most powerful force in the universe. But to get it to work for you, you have to start saving and investing early in life. Ackman believes that non-professional investors can earn 10% a year using a long-term investing approach and a value discipline. Over 40 years, 10% annual return multiplies your initial investment by 60 times. If you were able to put away $10,000 each year from your early twenties until retirement age, and earn a real return of 10% on these funds, then you can start with nothing and end up in the top 1% of the wealth distribution.

Before starting to invest, Ackman recommends paying off debt and building a cash reserve. If you have a lot of debt, then the miracle of compounding is working against you, until you pay off the debt.

Don't Lose Money

Warren Buffett has been quoted as saying that the first rule of investment is to not lose money, and the second rule is to never forget the first rule. To Ackman, this means investing in well-established companies with a strong brand or other competitive advantage, little or no debt and no controlling shareholder. And, of course, do not overpay.

Naturally, investing in the equity market means that the value of your investment goes up and down. This volatility in price is what most people think of when they think of risk. This is not what Buffett and Ackman mean. To them, risk is the probability of loss, i.e., permanent impairment in your investment.

Ackman's advice assumes that you are interested in finance and willing to do some homework on your investments. If you are not interested or unwilling, then Ackman suggests considering using a professional money manager. He suggests looking for managers with a value orientation and long-term successful track record.

Academic Advice

Most professors of finance and economics recommend a different investment strategy. Namely, you should maximize diversification and minimize fees. This means investing in one or more broad, passively managed index funds. The main rationale for this is the financial markets are assumed to be sufficiently efficient that it is very difficult for individuals, whether professional investors or not, to outperform the broad market averages. Many studies have confirmed that the bulk of professional money managers do not supply returns to their clients in excess of market returns. In a sense this is not surprising. After all, the majority of assets are managed by professional money managers so the aggregate return of such managers must be pretty close to market returns, and after netting out management fees, returns to clients underperform the averages.

Sure, some managers consistently outperform, but it is very difficult to tell from historical data which ones are going to do that in the future. The remarkable thing is since that retail investors can obtain returns very close to market averages by investing in broad index funds, they are able to outperform the average of market professionals, even though they are not market experts themselves.

Obviously, Ackman disagrees with the academic consensus. He thinks that a disciplined value investor has an edge, and that by cutting out companies that do not meet his specifications, he increases the likelihood of outperforming the overall market. Yes, Bill appears to have an edge – the ability to identify solid companies that are priced at a discount to fair value. The key question is this: do you have an edge?

If you do, then you should pursue it. If you do not, or if you are not sure, then the passive index fund approach is probably a good way to go.

Bill Ackman is an extraordinarily successful portfolio manager and he has put together a great lecture that contains a lot of valuable advice. But, contrary to the somewhat tongue-in-cheek lecture title, there is more to learn.