One Up to Earn:
Financial Education for Wealth Creation

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Abstract

You don't know what you don't know. There are always things that can be learned to better yourself. Learning about building wealth should be one of those things. Money can't buy you happiness but it can provide you with a sense of security. And along with that it can buy you time. This paper will look at how simple advice from financial leaders can help individuals look at what they might not know.

Keywords: financial education, investing, self-interest, motivation

Introduction

"... there are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns – the ones we don't know we don't know." [Rumsfeld, 2002] This idea was first mentioned by Psychologist Joseph Luft and Harrington Ingham [Luft Ingham, 1955] who used a model named the Johari window to illustrate the concept.

Let's take a look at an example of the Johari window by analyzing the details of a surprise party for a colleague named Rob. A "known knowns" would be that the surprise party collaborators "knows" that this is actually a surprise party. While a "known unknowns" is that Rob "knows" that this is a department meeting whose contents are unclear and has been led to believe an untruth. The "unknown knowns" is Rob knows about the department meeting, but doesn't realize that it's a surprise party for him. The "unknown unknowns" is that on the day of the surprise party, it could be cancelled due to a typhoon.

> "Unknown unknowns are future outcomes, events, circumstances, or consequences that we cannot predict. We cannot plan for them either.

We don't even know when and where to search for them." [Market Business News, 2020]

Figure 1. A modified Johari window (Market Business News, 2020)

One "unknown unknowns" that we cannot predict is future outcomes. But can you plan for them?

In a quest for wealth creation, learning about the knowns and unknowns can serve as a building block for personal financial education. An area in finance that seems to always draw some attention is investing in the stock market. According to Forbes, in 2020 around 50% of American households owned stocks, most of which had been purchased through a mutual fund that invest in a broad basket of stocks. The people who invest through mutual funds have been led to believe that investing in individual stocks are for professionals only and requires a lot of risk. This idea might particularly be directed at "day traders" since their only propensity for owning a stock is to make a quick buck. The analysis of trading-platform data shows that about 80% of day traders don't make money and go bust within two years. [Lyck, M., 2020] This is a big risk.

An unknown knowns for some is that the average stock market return was at 8% over that past 30 years with the S&P 500 bettering that at 10%. If we live by the rule of 72 [Pacioli, 1494], then we can expect that the average stock market investment will double in 9 years and an investment in the S&P 500 to double in 7.2 years. This takes into account

the dot.com bubble (2000-2002) and the Great Financial Crisis (2007-2008) where the stock markets loss more than 50% of its value. If earning that type of return seems appealing then a low-cost index fund is probably the best route without having to take much risk.

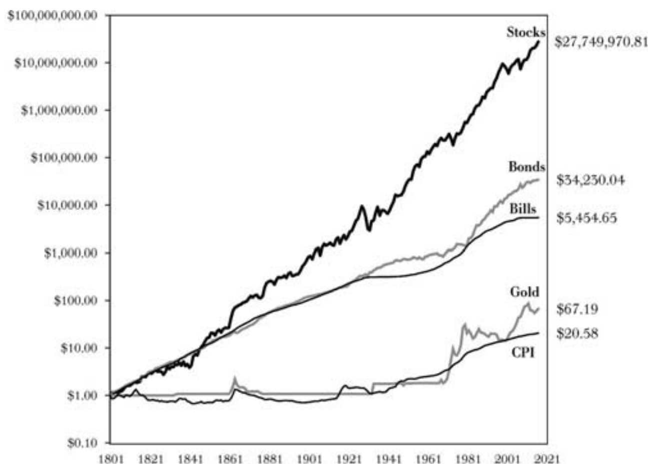

Figure 2. Stocks compounded return since 1801 [Malkiel, 2003]

For those trying to achieve higher returns, adopting Dweck's [Dweck, 2006] idea of a growth mindset, you should seek the "knowns and unknowns" for individual stock selection.

How to prepare for the knowns and unknowns

No one can predict the future with high accuracy or even with low accuracy. Instead, many people use past events and data to project into the future. If your mother lives to be 90 and your father lives to be 82, then how long will you live? You might assume that if you are a woman then you probably will live to be 90 and if you are a man, 82. This could be a fair assumption, but there are unknown unknowns that could affect your assumptions such as pandemics, accidents, etc. So is the case of the stock market, the long history of bull and bear markets provide the best way to use past returns to project future returns even with unknown unknowns that may be lurking in the shadows.

Planning for the knowns and unknowns in individual stocks involves taking some risk. Risk is something that cannot be avoided but it can be managed through low volatility investments and diversity. Let's start by looking at volatility. An example of a high volatility stock investment in early 2021 was GameStop's stock. Apparently, hedge fund managers were short-selling the stock in massive quantities since the financial statements from the company indicated a collapse of its retail business. A Reddit group named "r/wallstreetbets" got wind of this information and started purchasing GameStop stock to increase the share price and short-squeeze the hedge funds and in doing so sent the stock's volatility into orbit. A short squeeze occurs when a stock or other asset jumps sharply higher, forcing traders who had bet that its price would fall, to buy it in order to forestall even greater losses. Some hedge funds accumulated unbearable losses due to an unknown unknowns, in this instance "r/wallstreetbets".

Figure 3. GameStop stock year-to-date 2021 [Google Finance, 2021]

Now compare GameStop stock with Consolidated Edison, which is in the usually low volatility energy business. It provides energy to households, which is a basic necessity for society, and operates in a steady, but primarily boring sector. It is mainly because of these factors, the volatility of its stock is low. The range of Consolidated Edison stock price year-to-date for 2021 was 6.4% while GameStop was 1,914%. The difference in the range of price volatility was about 1,907%. Investing in a low-volatility

stock, like Consolidated Edison, is one way to reduce risk.

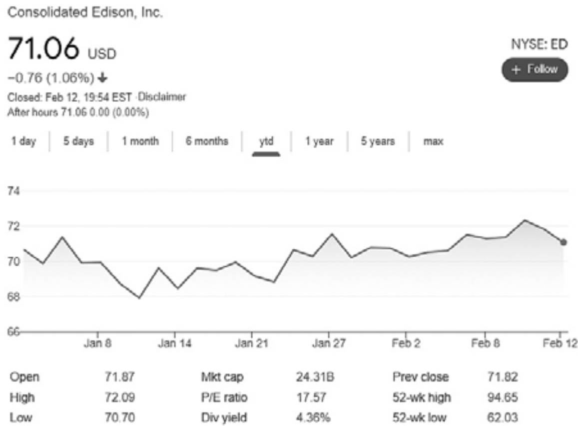

Figure 4. Consolidated Edison stock year-to-date 2021 [Google Finance, 2021]

Now let's look at the other way to manage risk, which is through diversity. Lynch [Lynch, 2000] argues and provides a chart which shows that having a diverse portfolio of say 11 stocks can allow investors to be rewarded from their investments by having just one big winner and holding on for the "long term", though in this case it was for only about 3 years. Long term generally means more than 10 years, and the longer a stock is held, the more likely it will give its typical return.

The table shows how investing an equal amount in a portfolio of 10 stocks (Strategy A) has a total return of 30.4%, which is indeed average, but having an eleventh outlier (Strategy B) elevates the total return to 110.6%. For those interested in the math, using the previously mentioned Rule of 72, that ends up being an annual return of a little over 28%. This means you would have doubled your investment amount in less than 3 years.

The future exponential price of the outlier was an unknown unknowns, but its place in the portfolio was most likely a unknown knowns. Afterall, if you are not blindly picking stocks, there must be some reason that it was chosen.

Strategy A Portfolio

	BOUGHT	SOLD	% CHANGE
Bethlehem Steel	$25 1/8	$23 1/8	–8.0%
Coca-Cola	32 3/4	52 1/2	+60.3%
General Motors	46 7/8	74 3/8	+58.7%
W. R. Grace	53 7/8	48 3/4	–9.5%
Kellogg	18 3/8	29 7/8	+62.6%
Mfrs. Hanover	33	39 1/8	+18.5%
Merck	80	98 1/8	+22.7%
Owens Corning	26 7/8	35 3/4	+33.0%
Phelps Dodge	39 5/8	24 1/4	–38.8%
Schlumberger (adjusted for splits)	81 7/8	51 3/4	–36.8%
			+162.7%

Strategy B
All of the above, plus

Stop & Shop	$6	$60	+900.0%

Figure 5. Diverse portfolio of 11 stocks [Lynch, 2000]

Diversifying using the known and unknowns

The forementioned Peter Lynch is an American investor, who achieved superior returns as a fund manager, espouses that we all have the ability to pick stocks that can be an outlier in good and bad ways in terms of annual returns. The big difference is that the good often outweighs the bad since there is a limit to a bad stock and is disproportionate to the advancement of a good stock.

The table reflects how outliers affect the final profit and loss balance. Stock A hasn't returned a profit or loss. Stock B (bad outlier) is a total loss, but capped at $1.00. Stock C (good outlier) has the disproportionate

Stock	Bought	Sold	Profit/(Loss)
A	$1.00	$1.00	$0.00
B	$1.00	$0.00	($1.00)
C	$1.00	$3.00	$2.00
Totals	$3.00	$4.00	$1.00

Figure 6. Disproportionate advantage. Does not include any fees.

advantage and shows a profit of $2.00, which leads to a positive final return of 33%.

Using our known knowns for unknown knowns can help with selecting individual stocks. One of Lynch's [Lynch, 2000] most borrowed idea is "Invest in what you know." This idea also relates to Warren Buffett's idea of the "circle of competence" [Swedroe, 2012] that has served him extremely well. In fact, Buffett is considered one of the most successful investors in the world and has a net worth of over $85.6 billion USD as of December 2020 [Wikipedia, 2020]. The idea here is to look at your life or society in general and see if there are any goods or services that you understand and affect you in a positive way now and in the foreseeable future.

Let's take a look at the unknown knowns for the year 2020 by looking at two individual businesses that you probably know or are at least familiar with (known knowns). The majority of us will consider 2020 as a lost year due to the pandemic caused by COVID-19. With outbreaks and lockdowns running amok among countries, there seems to be little to savor. Or is there? When the governments were locking down large portions of major cities, the rise of work-from-home employees took a sharp turn upward. This directive was essential to keep the economy from fully collapsing, and deal with the social distancing needed to prevent any further spread of the highly contagious virus.

Now let's consider the unknown knowns, work-from-home and social distancing, from an investing perspective. For many employees who were working from home, it still meant working but connected digitally to their employer for input and output. Some employers and even employees probably needed to purchase notebook or desktop computers so that the vital line of communication would not be disrupted. Since all notebooks or desktops need an operating system and productivity software, the businesses that specializes in this could benefit from it. And who more so than Microsoft, which licenses both Windows 10 and its Office suite.

The figure shows the one-year chart for Microsoft stock from February 12, 2020. The pandemic had a definite impact on the stock market and on Microsoft stock as seen in the March 2020 lows, but if you had considered the work-from-home and social distancing scenario (unknown knowns) and invested in Microsoft in April or even May, giving you a two-month opportunity from its March 2020 lows, your return for nine months would have been 34%.

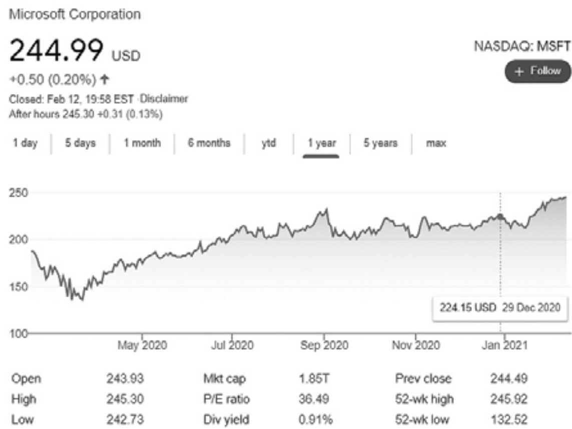

Figure 7. Microsoft stock 1 year [Google Finance, 2021]

Following the same path forced by the pandemic, many employers and employees realized they were best served to have video conferences to share information and touch bases. Video conferencing proponents claim that it can boost productivity, save time, reduce travel expenses, and overall promote collaboration. They also state that the advantage of video conferencing is the ability to facilitate all of those benefits without requiring constant travel for face-to-face communication. [Lifesize, 2020] Being a specialist in this area could be beneficial and a business that many are now familiar with is Zoom Video Communications or just Zoom.

The one-year chart of Zoom stock from February 12, 2020 could be an example of a good outlier that was mentioned earlier. Let's assume that again in April or May, you decided to invest in Zoom. Investing at the end of May, giving you about a two-month window from the declaration of the pandemic as acknowledged by the World Health Organization in early March, your return would have been an astronomical 141% for a nine-month investment.

Microsoft and Zoom are known knowns, in that their business is something that many are familiar with and use on a regular basis. The important part of investing in these two companies was the unknown knowns; for you had to look at the pandemic and how your future life would be affected by it to realize the potential each business could offer.

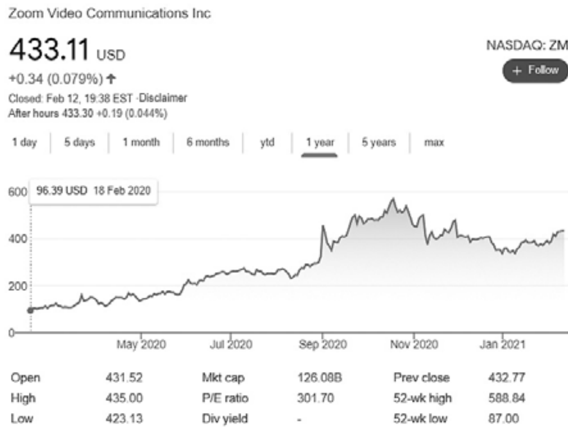

Figure 8. Zoom stock 1 year [Google Finance, 2021]

The work-from-home initiative and social distancing awareness were the catalyst for the glimpse into the unknown knowns future and the earnings growth that each company could provide.

Earnings growth is one part of a company's balance sheet that many financial analysts pay close attention to since it provides a way to value a company in the unknown future. If a stock shows rising future earnings growth, then the stock price will most likely rise with it to match its valuation. And for Microsoft its earnings in 2020 grew from $1.40 to $2.03, which is about 45%, and in the case of Zoom, its earnings in 2020 grew from $0.05 to $0.66, an amazing 1,320%.

Conclusion

Peter Lynch has stated that, "Average investors can become experts in their own field and can pick winning stocks as effectively as Wall Street professionals by doing just a little research." [Lynch, 2000] Using your known knowns to look at the unknown knowns for individual stocks can be a way to start your journey into stock selection. The 2020 pandemic offers an idealistic view of the selection of stocks since the unknown knowns were more obvious than usual. The two stocks that were examined here does not consider other factors reflected in the company's balance sheet

such as price-to-earnings ratio, free-cash flow etc. In most cases, using a known knowns to look at the unknown knowns for a stock, is the first step to see if further research is needed. As Lynch has shown, being correct in just one good outlier can reward the individual investor handsomely if held for the "long term". That and, if you have one available, a magic crystal ball.

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