The Unique Advantage of Equity Investment

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Investment in stocks has a unique advantage over other asset classes such as bonds and real estate. In my experience, this is rarely understood and almost never discussed.

Before we begin, it is important that you understand that stocks represent a fractional ownership interest in a business – not little pieces of paper or flashing ticker symbols on a computer screen.

The unique advantage is that stocks can compound in value in a way that bonds and real estate cannot. The reason is simple: companies retain a portion of their earnings to reinvest in the business. The earnings that are not paid out as dividends are plowed back into the business. No other asset class provides this.

If you own bonds, you receive an interest payment but it is not reinvested in the bonds. Similarly, if you own an apartment unit, you will receive rental income but none of it will be automatically reinvested in the property for you. It is your job to take the after-tax proceeds and invest it elsewhere. There are two drawbacks with this:

1. Your income is taxed immediately
2. You must find another investment idea

In both cases, nothing is retained back. So the "book value" of this "business" does not grow because 100% of earnings are paid out as dividends.

Now, let's talk about stocks. In most businesses, not all earnings are paid out as dividends – a portion of the earnings are retained. If these retained earnings are reinvested wisely, then every $1 retained will translate to more than a $1 increase in market value. There are two advantages to this:

1. Tax deferral on unrealized gains
2. Attractive automatic reinvestment

What gets me really excited is the prospect of investing in companies that earn a high return on its capital and has the capacity to reinvest at equally high rates. These businesses are internal compounding machines. In such a case, the last thing you should want is for the company to pay a fat dividend.

Furthermore, most real estate projects fail to deliver mid-teens unleveraged returns. Their real returns are likely to be much lower after factoring in for property tax, stamp duty, legal fees, vacancy, repairs, interest expense, broker commission, transfer fee at the land department, time spent fixing tiny things, time spent following up on rent, project delays, etc.

Stocks, on the other hand, comes with no such strings. *If* you are right about the business and the management – and you don't overpay – the business will do all the heavy lifting for you. This is the ultimate form of leverage.