Passive Income in The Age of Social Media

"In investing, there's no such thing as a free lunch." - Benjamin Graham

Throughout history, particularly in times of financial exuberance, investors have fallen victim to fanciful narratives promising effortless wealth and extravagant returns. Dutch tulips in the 1630s, U.S. railroads in the 1870s, internet stocks in the 1990s, digital photos of rocks and monkeys in the 2020s, all captured the imagination of countless 'investors' chasing once-in-a-lifetime investment profits. Unfortunately, as Warren Buffett's wise teacher, Benjamin Graham, put it so eloquently: *"In investing, there's no such thing as a free lunch."* The investments that seem too good to be true generally are, and those unlucky investors that decide to leave common sense behind and chase the dream of untold riches end up in rags and full of regret.

In the age of social media, platforms are inundated with stories of overnight success and exaggerated claims of financial freedom through *passive income streams*. While these narratives may capture viewers' imagination, as they daydream about a world where they no longer have a 9-5 job, they often mask the harsh realities and complexities inherent when investing. Furthermore, they ignore the risk of loss and focus only on the potential upside. If there is a 95% chance of losing your entire investment, even a 400% potential return does not adequately compensate you for making the investment. Sadly, while many chase their dreams of passive income and financial freedom, masqueraded as "investing", they unknowingly are gambling away their savings.

It is easy in retrospect to point at those that have incurred losses on speculative gambles, and proclaim they deserved to lose their investment due to greed. However, in the moment, many lose sight of reality and convince themselves they are making a prudent investment. Unfortunately, most do not have basic investment acumen and in following the herd off the cliff, believe they are doing the right thing for their financial future. Concepts like risk of loss and probability of outcomes are foreign and distant, while the dream of a financial windfall feels tangible and within reach. This is the reason so many fall prey to financial bubbles that promise investment riches.

Over a 20-year investment horizon, the concept of compounding emerges as a fundamental principle in wealth accumulation. In the proverbial investing race of the tortoise and the hare, the slow and steady tortoise has little fan fair but a track record of undefeated results. While society and especially social media as of late portray rapid wealth accumulation as the key to financial success, the truth is more subdued. Realistic investments, such as diversified portfolios of stocks and bonds or reasonably leveraged real estate portfolios offer modest yet sustainable returns over time, compounding and producing true financial freedom. Reducing the risk of loss and allowing investments to grow exponentially, with returns reinvested to generate additional earnings, the compounding tortoise produces unmatched results. However, it's crucial to acknowledge that compounding operates within the parameters of market realities, devoid of the inflated claims perpetuated by whatever the bubble of the week is currently boasting.

Investments that promise outsized returns often come with elevated levels of risk. As Howard Marks astutely observes, "High returns come from high risk, but every risk doesn't lead to high returns." While the allure of quick riches may be enticing, the consequences of capital loss can be severe, impeding long-term investment growth. It is imperative to prioritize the preservation of capital, understanding that prudent risk management is the most important factor to sustained financial success.

To illustrate, let's compare two investors who both aspire to achieve financial freedom. Ms. Tortoise and Mr. Hare both aspire to achieve financial independence, and both have $20,000 per year to invest. Ms. Tortoise has decided to stick to a slow and steady safe path. Each year she invests $20,000 into index funds that have historically returned 8-10%. In Year 1 she only earns $2,000 from her $20,000 investment. Hardly worth getting excited about. After all, the goal is financial freedom. Mr. Hare has taken a different approach. He plans to jump in and out of investments, chasing the next hot thing. In Year 1 he invested $20,000 in a mixture of GME stock, NFT rocks and multifamily syndication in Phoenix, AZ. At the end of Year 1 he doubled his investment, and his portfolio is now worth $40,000. If he can keep doing this, even if he only hits 50% returns per year, he will be on the road to riches.

In Year 2 Ms. Tortoise, although jealous of Mr. Hare's newfound financial success, adds another $20,000 to her index funds and at the end of Year 2 has made $4,200 of investment income. Mr. Hare has caught the real estate bug and uses his $20,000 as a down payment to purchase a $240,000 property in another state where he plans to run an Air BnB. Although it was a rocky year for Mr. Hare, he was able to squeak out $30,000 of profit. He has now amassed over $90,000 in just two years! Ms. Tortoise is kicking herself for not listening to her friend Mr. Hare, she has only amassed $44,200 in the same time.

In Year 3 Ms. Tortoise sticks to her plan and invests another $20,000 into the same old boring index fund. She has a decent year earning 11% and her investments grow by just over $7,000. She has now built a portfolio worth $71,200. Unfortunately for Mr. Hare this was the year the rubber met the road. His Air BnB ended up needing a new $20,000 roof. He was not able to make any new investments because of the roof replacement. Even worse, the occupancy on his Air BnB dropped 50% and he had to come out of pocket to cover his mortgage payment. His NFT rock lost 70% of its value. GME struggled and ended the year down 40%. Worst of all, his multifamily investment went into foreclosure after the rate lock expired. Mr. Hare did not know how to properly vet the general partner he invested in. At the end of Year 3 Mr. Hare's investment portfolio sits at a depressing $36,000 in value, a $24,000 loss of principal.

Obviously, this is a dramatized illustration but not all that detached from reality in the case of Mr. Hare. It is not uncommon for folks to hope from one get-rich-quick investment to the next, hoping to strike it big. Sadly, the odds of success are stacked against them, and they rarely produce adequate returns on their investments. At the same time, if Ms. Tortoise sticks to investing $20,000 per year for the next 20 years and averages 10% returns per year, she will have amassed $1.26 Mil. A huge sum from a very manageable investment strategy.

The pursuit of passive income and financial freedom is a worthwhile endeavor; however, expected investment returns should be grounded in common sense. When the promised returns you chase reach a level of foolishness and lunacy, you are no longer considered an investor but rather a gambler. For some, the gamble may be worth it, but when principle is lost, and the financial harm cannot be undone there is no one to blame but yourself. Be like Ms. Tortoise and not like Mr. Hare.