The Investing Portfolio that Will Preserve Your Wealth and Your Sanity

DAVID GAFFEN

Never Buy
Another Stock Again

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David Gaffen

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Publishing as FT Press
Upper Saddle River, New Jersey 07458

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Printed in the United States of America

First Printing December 2010 with modifications January 2013

ISBN-10: 0-13-707155-8
ISBN-13: 978-0-13-707155-5

Pearson Education LTD.
Pearson Education Australia PTY, Limited.
Pearson Education Singapore, Pte. Ltd.
Pearson Education Asia, Ltd.
Pearson Education Canada, Ltd.
Pearson Educación de Mexico, S.A. de C.V.
Pearson Education—Japan
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Library of Congress Cataloging-in-Publication Data

Gaffen, David Aaron, 1973-

Never buy another stock again : the investing portfolio that will preserve your wealth and your sanity / David Gaffen. — 1st ed.

p. cm.

ISBN 978-0-13-707155-5 (hardback : alk. paper) 1. Investments. 2. Index mutual funds. I. Title.

HG4521.G17 2010

332.6—dc22

2010024184

For my children, Lily and Noah.

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Acknowledgments

The entirety of this book would not be possible without the counsel and experience of my agent, Jeffrey Krames, who contacted me about writing a book more than two years ago and before I had any idea as to what I might want to write about. Needless to say, he was hands-on as ideas were developed and has been a great ally. The book would not exist without him.

I need to thank, as well, my editor, Jeanne Glasser, who has been steady in her belief in the book's value, provided careful and useful edits, and was encouraging and understanding through the entire process. Jeanne and the rest of the editing and production staff at FT Press are crucial to this book's success.

I cannot go without the acknowledgement of those in the industry who provided wise thoughts and took the time to explain their views extensively about this market. I interviewed many during the course of this book's development, but in particular would like to mention Jeffrey Rubin of Birinyi Associates, Diane Garnick of Invesco, and Rob Arnott of Research Affiliates, who deepened my understanding of the markets.

I would also like to mention the journalists who have inspired me over the years and contributed to my growth as a writer and reporter, including but not limited to Suzanne Pavkovic, David Mark, Sailaja Sastry, Todd Bell, Dan Carroll, Jamie Heller, Aaron Task, John Edwards, Ron Lieber, David Geracioti, Matt Barthel, Geoffrey Lewis, Pat Fitzgibbons, Mark Gongloff, Cindy Perman, Tim Annett, Jennifer Ablan, Bill Schomberg, and Chris Sanders. I owe a massive debt to fellow traveler Erin Arvedlund, who prodded me throughout the process and provided valuable tips to make this book much better than it could have been without her efforts.

My thanks also go to my employer, Thomson Reuters, which gave me the support and time to take on this project. This work does not reflect the opinions of my employer as it is solely my effort.

I'd be nowhere without my mother and father, and my sister, Jessica, who remember the days when I'd struggle through English class due to a lack of interest in writing. How things change.

This book came about at a rather busy period in my life, coming a few months before and after the birth of my second child, Noah. In between late-night feedings I set these words to paper, often sitting on a stepstool with my laptop propped up on the bed while my daughter, Lily, was across the hall trying to sleep. My children are my treasure, and the need to comfort my daughter by being in her vicinity was an interesting way for me to discipline myself by using the time spent upstairs to write more.

I'm going to end with some words for my wife, Dana, who has been unwavering in her support for me. It's not easy to juggle two kids and full-time jobs, but she was there to pick me up when I was feeling frustrated and celebrate the high points with me as well. This book is for you. I love you very much.

About the Author

David Gaffen has been covering the ups-and-downs of the financial markets for 15 years. He is currently an editor at Reuters, overseeing a team that reports on the stocks, bonds and foreign exchange markets. He was the founding writer and editor of the *Wall Street Journal's* MarketBeat blog, which he wrote for more than three years, and was nominated for an Editor and Publisher Eppy Award. He has made numerous TV and radio appearances, including Fox Business, CNN International, and NPR. He lives in Westchester County, New York, with his wife and two children.

While this book was written during his tenure as a Reuters editor, Reuters has not been involved with the content or tone of this book, which are his responsibility alone.

Introduction

I come from a family of careful investors. There's a theory that people who have not experienced the kind of hardships that Americans faced throughout the Great Depression are more cavalier with their money, but that didn't extend to my family. At the end of every month, I take my spare change, put it into paper coin rolls, and deposit them at the bank, a habit learned from my grandfather. He was one of the all-time great penny-pinchers, who did suffer through the Depression.

But many in recent years forgot about the past—and they repeated it in horrific fashion. Investors with little or no experience in markets were lured into investing in stocks after more than two decades of terrific gains in the equity market, and they got their head handed to them after tech stocks tanked in the early part of the 2000s and the rest of the market was destroyed in the last part of the decade. Stocks have since come back dramatically and then faltered again, leaving many investors wondering just what to do and whether they'd do better just to leave their money under the mattress.

I didn't write this book to validate your feelings of fear. I've been watching and investing in markets for 15 years as a financial reporter and editor. I think I've learned a few things, but much of what I've learned hasn't been emphasized by big brokerages or popular media.

I originated, and for three years was the primary writer of, the *Wall Street Journal*'s MarketBeat blog, one of the most popular blogs on WSJ.com's Web site. Now I work as an editor at the newswire Reuters overseeing the markets group, so I have a close eye on the

ups and downs of the volatile stock market. I've come to understand that most investors don't adequately understand the risks embedded in the stock market, and I'm here to try to explain some of them. In the years I've been writing about markets during my years at TheStreet.com, the *Wall Street Journal*, and now Reuters, I've met many investors who thought they had it all figured out, and I've also known many who understood the market was an unforgiving beast that could move against them at any time. Those who kept their guard up did better.

In reality, much of the best advice doesn't stray far from my grandfather's desk in his basement, where I watched him as he hunched over, meticulously putting quarters into rolls.

As someone who has been monitoring the markets for the better part of 15 years, I can say for sure that stocks are not the best—and sometimes one of the worst asset classes, because there are times when the stock market, when taking out transaction costs, management fees, and inflation, really does not give you much at all. But this book is not about finding some kind of new way to avoid the asset class that has been the mainstay of investing for decades, because stocks have provided strong returns overall that other investments, like bonds, cannot match.

This book has another purpose: To let you know you don't have to bother with individual stocks at all. Those investors who aren't willing, or do not have the time, to adequately research individual stocks in the equity market should start instead with index funds. Stocks can't be ignored completely, and to stick your head in the sand and pretend you're going to fund your retirement with bonds and not much else would be just as foolish as relentlessly buying equities no matter how bad the selloff.

Along with that, this book will show how a little bit of flexibility and common sense can go a long way to preserving your assets. And keeping your itchy fingers away from the keyboard will help prevent you from ruining your returns with excessive trading while increasing

your anxiety. Because if trading costs and management fees are going to kill your returns, it makes the most sense that you should try to cut those down to as little as possible. Thankfully, there are ways to do this.

I'm going to focus on getting you to put much of your investing assets into index-style investments and exchange-traded funds that track major indexes. You're going to have to limit your trading and avoid high-cost brokerages to keep your costs low, and you're going to learn the importance of rebalancing your portfolio to help keep you on the path you want to be on for retirement. Finally, there's diversification, but this diversification is much broader than what you're accustomed to hearing about.

The main practical suggestions for you are in Chapter 10, "Putting It All Together," where I break down my ideal portfolio, one that's less equity-centric and designed to keep costs low. Before that, I'm going to look at ways investors get themselves into trouble and how you can avoid perilous situations—and also how to understand that they can't be circumvented completely.

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1

Starting Over

"Managing money is difficult, time-consuming, draining, and a totally alien experience for almost everyone who has come out of the educational system of the United States, where, if you are lucky, you may have learned the difference between a stock and a bond."

Jim Cramer, *Jim Cramer's Real Money: Sane Investing in an Insane World,* 2005

Visitors to this planet from another galaxy in the late 1990s or through most of the last decade would have probably bet the national pastime was not baseball, football, or any other sport, or even reality television—but the stock market. Investing has long since ceased to be the boring activity your grandparents and parents engaged in (usually by purchasing safe securities like zero-coupon bonds) and a run-and-gun activity full of amusement for people willing to sit in front of the computer screen for hours at a time—and there are many such people.

That's because the 1996-2007 period featured two of the greatest bull market runs the U.S. market has ever seen, each of which carried stocks beyond most expectations—from 1996 to 2000 and the 2003-2007 market. With that came the ballooning of incredible expectations on the part of investors. The prowess of the market extended beyond its initial purpose of growing one's assets, but instead the investor class had come to believe that virtually all of the nation's problems could be solved through the wonders of financial markets.

Unlike the post-Depression era, when mom-and-pop investors shunned stocks, investors in this era were conditioned to believe that stocks would always rebound after any and every kind of decline, no matter how precipitous.

This begets a serious misunderstanding of the reality of the risk in the equity market. The prevailing wisdom—that you could never lose money on stocks in the long run—coalesced into a few investing tenets that took over the psyche of the traditional investor. Think of the following three rules as the investor's mantra during this time:

1. Buying and holding stocks is the only strategy.
2. When stocks fall, buy more stocks. Selling is for losers.
3. When confused, see rules #1 and #2.

Essentially, investors were instructed to buy, regardless of the economic situation or short-term fluctuations, because invariably, stocks would rebound. These precipitous drops were merely a buying opportunity (regardless of how much of one's capital was tied up in these supposedly amazing investments that had recently given up substantial value).

This type of learned behavior, which relies on a modicum of historical knowledge and a bit of hope, is difficult to change. Just as the post-Depression era investors missed out on substantial gains in markets because of ingrained prejudice against riskier investments, the reverse was the case with investors of this generation, conditioned to see every pullback as just another reason to keep hungrily buying stocks. Investing, generally thought of as a staid activity, captured the cultural zeitgeist.

In late 1996, Alan Greenspan, in testifying to Congress, used a phrase to describe the state of affairs regarding the financial markets that, for his remaining years as Federal Reserve chairman, would forever be associated with him, asking whether "irrational exuberance" had "unduly escalated asset values." His pessimistic "irrational

exuberance" phrasing prompted a sell-off on Wall Street that day, and garnered him scathing criticism from just about everyone.

More than a decade and two harsh recessions later, it's clear the chairman was onto something—even though he had stepped back from those remarks later, by arguing that asset bubbles could not be identified, and therefore the Fed, the authority in charge of keeping interest rates at proper levels, could not do anything about it.

In those years investors enjoyed the fruits of easy credit and technological breakthroughs that caused stocks to skyrocket to new levels. This culminated with the ascent of the Dow Jones Industrial Average to top 14,000 in October 2007. (At the time of Greenspan's speech, the Dow was marking time at about 6,400.) And in that time, the Fed chairman became something of a minor celebrity himself, inspiring a "Get Exuberant!" fan Web site and being lauded with the moniker of "Maestro" for his seemingly impervious ability to navigate markets through troubled waters.

Oddly enough, between 1996 and June 2009, while stocks had put together a healthy 53 percent on a total return basis since Greenspan's ill-received remarks in 1996, it was dwarfed by another asset—a bit less risky one, the risk-free, three-month Treasury bill! An investor who bought treasury bills in 1996 and consistently reinvested them would, by the end of June 2009, have racked up a 56 percent return, according to Bespoke Investment Group, a research firm in Harrison, New York. That's about three percentage points better for an investment that couldn't be safer or more uncomplicated. And that 53 percent gain in stocks only came if one never pulled out of the market and then later picked a bad moment to put money back into stocks. Mis-timing the market is one of the hallmarks of the individual investor, and it's one that served them particularly poorly in the last 13 years. (Note: The subsequent outperformance of stocks in late 2009 and the first half of 2010 left the three-month bill in the dust, but it shouldn't really even be a race in the first place.)

During that period, a cottage industry of market mavens sprouted up. That's not surprising: After all, in 1983, just 19 percent of Americans owned stocks, most of those being direct investments in companies by the very wealthy. By 1998, that figure increased to about 63 percent (counting mutual funds and retirement accounts), and it was up to about 68 percent in 2007, though again, most of the growth has come from ownership of mutual funds and in retirement accounts.[1]

Through that period, the frequent refrain from investors, particularly those with only a cursory knowledge of equities, was that stocks were the best investment, bar none, and investors had to hold them ad infinitum. In doing so, you'd not only be helping yourself, you'd be doing a patriotic thing by buying into the great U.S. capital system, and you'd also be sure to have a great time as well.

Enough

The term "catharsis" is an ancient Greek word that means "purification" or "cleansing." It's that moment when a group of individuals, having finally exhausted their patience, reaches an emotional peak and collectively cries, "Enough!" For a time, it appeared that the 2000-2002 period, which featured the demise of the technology bubble, might serve as this moment for scores of investors. It was not, though, thanks to low interest rates that spurred a frenzy of borrowing—money that was put into the stock market.

The 2008 period seems more likely to serve as catharsis. The horrific debacle in the financial markets revealed a financial structure built on the shifting sands of borrowed money and assets that could not be valued. The likelihood is that the stock market has seen its best days for some time.

But the market's 2009-2010 rally suggests that old habits die hard. So this book is intended in part as catharsis—to jar you out of the thinking that has permeated the mind of the individual investor, mostly through osmosis and the droning of the litany of pundits on

television mostly arguing the same thing: That you should leave your money alone and not worry, because in the end, it'll all work out. Does such advice make sense in any other aspect of life? Nobody expects automobiles to run in perpetuity without tune-ups and oil changes; houses that go without upkeep aren't so pretty when the grass is overgrown and the paint is peeling. But a portfolio of investments, somehow, should be set aside in the expectation that you can wake up, Rip Van Winkle-style, some three or four decades later with your retirement goals achieved and your worries cast away in the wind.

It doesn't work that way. That said, others like to take things to the other extreme. Financial television features a daily assault of commercials designed to convince you that your investments are somehow missing something without this new product, preferably one you can trade often. It's not the same thing as the relentless pumping of the new investments that cropped up during the technology bubble, but it is faddish in its approach, and in a way involves investment in the next hot money-maker.

In this book I suggest avoiding all that and instead advise concentrating on preservation of capital and realistic expectations. Most people say their expectations are modest: They expect returns of 8 to 10 percent each year. But a few years of outperformance, such as what existed in the late 1990s and middle part of this decade, has a way of upping one's need for greed. People become less satisfied with modest outcomes, particularly if they see others doing better.

The main point of this book is that most people should avoid buying individual stocks. It is a lot harder than it looks. The majority of small investors simply do not have the time or emotional make-up to pick individual stocks. A much better alternative is stock index funds or exchange-traded funds (ETFs). Not only are they cheaper, but you are much more likely to walk away having made money.

Investing is not like Wii Tennis or Sudoku: It's not a game. The decisions you make affect you for the rest of your life. A few people in the world have enough money to throw it around on every fad that

comes up, but more than likely, they didn't get rich that way. Investing for one's later years or education for children cannot be done over if it doesn't work out the first time, which is why it is important to be prudent. It's why it is important not to allow hackneyed clichés to take the place of sound understanding of one's goals, how to achieve those goals, and avoid deviating from them just for a chance to play in what the popular media portray as a quizzical game where everyone wins. It's time to say, enough.

Deprogramming

Part of what caused this amazing run in the equity market was an unprecedented period of relatively stable economic growth. After the harsh recession of the early 1980s, the economy suffered just one contraction between 1982 and 2001, in the early 1990s. Fed chairman Greenspan sometimes talked of the "Great Moderation," the period of time when economic cycles became less volatile and less disruptive, and certainly this period, encompassing nearly two decades, qualifies.

During this period, several significant developments occurred that facilitated the greater involvement of investors in the equity market. For one, interest rates declined from double-digit rates as part of Fed chairman Paul Volcker's effort to choke off inflation. Lower rates supported borrowing, which supported the equity market.

Second, the creation of the 401(k) plan, the 403(b) retirement vehicle, along with the individual retirement account and specifically designed accounts for individuals to sock money away for education for children, piqued interest in equity investments. "There were all of these plans to save for retirement that hadn't been there before, and suddenly America had a way to invest in the stock market in a tax advantaged way," said Kevin Flynn, head of Avalon Asset Management, an investment advisory in Massachusetts. "There was a wonderful excitement in the investment world for years."[2]

The spirit of this feeling was captured in a commercial for discount brokerage Charles Schwab in the late 1990s. Olympic skier Picabo Street is shown in a weight room talking about an unspecified "crash." Since she had broken her leg in an awful wipe-out the year before, the natural assumption was that she was discussing skiing. She then makes it clear that she isn't speaking about skiing at all—she's referencing the one-day, 22 percent decline in stocks in 1987, which she concludes was a buying opportunity, and not a crash.

With that in mind, the massive explosion in interest in the stock market rewarded investors with staggering outperformance. The Dow industrials put together a streak of nine consecutive years of positive returns, and between 1996 and 1999, the Dow industrials returned more than 22 percent in four of five years (the straggler was a still-terrific 16 percent gain in 1998). It's no wonder that the three-year bear market lasting from 2000 to 2002 did not dissuade investors from the by-now accepted behavior that buying again was the most prudent course of action.

The hangover from those gains was easy for investors to dismiss. Plenty of people simply brushed off those losses, rationalizing the 2000-2002 period as a consequence of overly optimistic buying of Internet companies that did not make money. (The 9/11 attacks also hastened the decline in equities.) Investors went back to their old ways, buying heavily in stocks—and as we shall see, real estate—but this time, doing it by borrowing lots of money, using their houses as a casino with home equity loans. And what was merely risky—putting all of one's eggs in one basket, that basket being the stock market—became downright foolish when they were somebody else's eggs.

It's been a tough lesson to learn. Since 2003 investors have found that the old saw about stocks being the best investment for long periods of time has not held up. Since 2000, the Dow has finished higher in four years, and finished lower in five years, including the devastating 34 percent decline in 2008.

But even after such a lackluster period of performance—what is already being referred to as America's "lost decade" in equities—learned behavior is hard to change. There's an odd paradox at work here: Investors are told to avoid selling stocks in response to a sharp decline, because that's considered "panicking." But frenzied upward moves in equities are not met with the same cautious advice—investors are instead told they'd better act lest they "miss the rally." Either way the prevailing advice defaults in favor of buying more stocks, and also happens to be the one guaranteed to cause the average investor the most stress—you're either sweating out sharp declines in stocks while doing nothing, or instructed to dive right in again after losing lots of dough. This is a particularly curious set of rules to follow, because long-run statistics show that most major markets, at one time or another in their history, have lost about 75 percent of their value. This tends to happen when the greatest number of people have convinced themselves of the market's value and are most leveraged to continued success in the market.

Even after the horrific bear market that commenced in late 2007 and saw stocks fall to 12-year lows in March 2009, investor behavior has still been slow to change. Between March 2009 and late August 2009, the stock market rallied by 50 percent, and the investor populace, forever convinced of the stock market's superiority, rushed headlong back into the equity market. In January 2009, assets in money market funds, a safe, cashlike investment, hit a peak at $3.92 trillion. By the end of August, more than $300 billion in that capital shifted out of those money market funds and back into stocks, according to Mizuho Securities.[3]

Confidence among investors, while not shattered, has been eroded. After the sharp move back into the market among mom-and-pop investors in the summer of 2009, money market fund assets remained at a stable level as the market continued to rally, suggesting investors had become a bit more gun-shy, and equity inflows, according to the Investment Company Institute, trailed inflows into fixed

income funds, suggesting that the overall appetite for risk has shifted away from stocks. But it's hard to say whether hope springs eternal here—in 2010, data on flows into equity funds started to show, once again, that investors were getting back into stocks, after a gain of more than 60 percent, the biggest 12-month rally in the history of the Standard & Poor's 500 stock index. Once again, individuals are showing their shortcomings, and they appear, once again, all-too-willing to forgive and forget, and go back to what's familiar. Are you one of those investors? Did you stay away for 2009 and then jump back into the market in 2010 after a spectacular rally that had already concluded? You're not alone—and your sudden enthusiasm comes just as institutions, which have made hay off the 2009 gains, are finding the environment a little more circumspect.

Investor tolerance for risk has been at least somewhat altered, though—a report from consultancy Spectrem Group published in October 2009 noted that newly conservative investors with assets of $100,000 to $1 million were unlikely to change those behaviors in the long term, citing the sharp decline in their portfolios. Cash had become king, and bond market investments looked better as well. They were also monitoring their investments more closely, as 55 percent of the nearly 2,000 surveyed said their losses had "seriously impacted" their long-term financial plans.[4]

The greater attention to detail is a positive development, as is a newfound realization that the market would not provide rich gains for year after year. In a sense, this is the new version of the Great Moderation—the moderation in investment behavior that deals with the reality of gyrations in financial assets and attempts to insulate against it, rather than simply assuming all goes for the best. Time will tell, however, whether this recent streak of cautiousness we've all adopted goes by the wayside if stocks continue to perform well, or whether behavior has been changed irrevocably. The way things usually go is that people swing from one extreme to another—the average American remained deathly afraid of the stock market for years after the

Great Depression. Once the love affair with equities was rekindled in the mid-1980s, though, it was impossible to give up for so many. Margin borrowing rose, people borrowed on home equity to finance purchases in the stock market, and America made unlikely celebrities of Fed chairman Alan Greenspan, CNBC anchor Maria Bartiromo, and Jim Cramer of TheStreet.com.

Now, after an ugly two-year recession that has left the economy overleveraged and on shaky footing, Wall Street doesn't have a lot of friends. Data on mutual fund inflows suggests that the ingrained mistrust of brokerages, which remained at a simmer when things were going well, is red hot. You're looking to preserve your capital, and right now the government seems like a better place than anywhere else.

But that would be a fool-hardy approach, because the government bond market is likely to provide very limited returns.

We'll get to the specifics of what to do there in a bit. The first task, however, is deprogramming: It's retraining your mind to understand that the reflexive advice you've been hearing for the last decade-and-a-half (in the face of all evidence pointing the other direction) should be largely ignored. There are a number of good lessons in the long-run historic data in the stock market, which we'll look at shortly, but few seem to acknowledge that simply repeating mantras about staying in the market at all times is not the path to success. Mutual fund data, for now, seems to suggest that investors may have finally gotten the idea when it comes to this—and it only took a couple of really, really hard blows to the head to figure it out. If the definition of insanity is doing the same thing time and again while expecting a different result, well, the bulk of stock pundits would have been put in a white room with padded walls a long time ago.

Those of you looking for easy answers will not find any such comfort here, and you should be wary of anyone who gives you the impression that this—managing your money—is an easy task. It is

not. It will frequently be stressful, and it is naturally going to be emotionally taxing at times. Yes, it can be fun—particularly when things are going well. But they're not going to always go well. And the complex nature of it is part of the reason why I am advising, in general, to avoid complicating already tough decisions with individual stock investments. Your time is better spent elsewhere. In these pages we will go through the various basics for getting your portfolio set up, so your assets can be in sound shape for what is likely to be several more years of tumult.

But the first lessons are going to be in psychology and in nerves. Those who stay alert and skeptical tend to fare better, even if for a few years they were considered stodgy because they refused to go all-in and bet on the most aggressive investment that was being proffered by talking heads and Wall Street brokerages. I've also been investing for years—making plenty of mistakes along the way—and have come to realize that those who don't have the time to try to outperform markets should look to work with their money as best as they can through keeping their costs low and their losses at a minimum. It's simple advice, as much of the advice in this market tends to be, but it's not well-followed, as the historic performance of the individual will show you. Learning that there are limitations does not mean you can't put together a portfolio that will stay relatively strong during tough periods—you have to accept some losses, after all—and do well during the good times.

With that, it's time for a few aphorisms that could come from the mind of Al Franken's Stuart Smalley character from "Saturday Night Live," the relentlessly optimistic self-help counselor. Consider them ways to keep yourself humble and in a cautious frame of mind when the market gets out of control. Here are Gaffen's four rules for investing:

1. You don't know everything. This is okay.
2. You're not missing something by not buying _____.

3. It's okay to move money from one asset to another.

4. It's okay if you lose money. Accept this as part of investing.

Much of the conventional wisdom the market belches out revolves either around the notion that you can do this better than anyone, so go for it!, or that you should give your money to someone who presumably does know everything. It's the nature of this market that we will continue to strive for that ideal, that market-beating mechanism that will work for infinity, and not just a lucky streak of six years or something, which we'll talk about at length in the coming pages. But admitting you don't have all of the information is merely prudent. Recognizing your own limitations as an investor is crucial; it's one reason why you picked up this book! This will also allow you to keep your objectives clear and your philosophy simple: that low-cost investments, keeping yourself away from big losses in your portfolio, taking advantage of opportunities that will keep taxes low, and strategic shifting of your money and proper diversification, should keep you in reasonably solid shape for the bulk of your investing life.

The second point—that you're not missing something by skipping on the fad of the week—is key. It's one we'll discuss at great length, as many people have convinced themselves of the better mousetrap, only to lose everything. This is fine if you have a million dollars lying around to play with. (I still don't recommend it, but knock yourself out.) But your nest egg is not for playtime. If the industry or stock in question becomes successful, buying large, total market indexes will eventually see the fruits of this, and if it doesn't, well, you haven't lost much. This goes for new products or different asset classes that somehow are advertised as insurance against any and all pitfalls (Gold! Commodities! Hedge funds! Alternative Assets!). But with the exception of a government debt instrument that's rolled over consistently from now until you eventually die and leave your assets to your children, there are almost no guarantees in terms of getting your money back. Annuities have such guarantees, true, but there are costs to be

considered as well. Pensions have a defined guarantee, although with so many big municipalities and states in trouble around the U.S., who knows how that'll turn out. But for self-directed investments, other than government debt, the guarantees are few. And government debt is not going to get you the kind of asset appreciation that will fund your retirement, not if you live for 30 years after you finally turn in your keys at the office for the last time. This is the reason why other riskier assets are the ones people lean on in their portfolios.

The third point—that it's okay to move money around—is one that's been lost for decades amid the ridiculous rise in the equity market. It took mutual fund investors a while after the gut-wrenching losses of 2008 and early 2009, but mutual fund data shows investors getting back to the stock market in 2010—after they'd already missed what is likely to be the best rally of their lifetime. And it's a sign of the reflexive belief in the stock market's role as savior of all that is good and holy. But you're allowed to sell your equity holdings if they are moving against you; simply leaving them alone does not make you prudent or heroic. With the proliferation of exchange-traded funds and mutual funds that invest in currencies, commodities, real estate, corporate debt, and hard assets, you're not forced to stick with a mundane stocks/bonds split.

The last point is perhaps the most important. Many people open individual retirement accounts and 401(k) accounts and overweight in stocks, particularly if there are hot funds available looking to capture strong performance in bank stocks, small-caps, technology, emerging markets, or corporate debt. But suddenly, things aren't going well, and now that fund in question is down substantially from where you purchased it. Well, the historical data is not going to help you. The fund is up 30 percent in the last two years? That's great, but for someone else—you weren't there for it. So take a deep breath and repeat after me: I'm allowed to sell this. You've got a lousy fund that's not getting anywhere? I'm not talking about a fund that's only up a few percentage points while everything else runs to the moon—that's perfectly acceptable. I'm talking about a dog, something that's getting killed, down

15 percent while the rest of your assets go nowhere. If it worries you that much, get rid of it—you've lost 15 percent on it but you won't lose any more.

If you do sell certain investments, you're going to risk the possibility that they come back in a big way. This has to be accepted. You're going to risk also that cash does nothing (as it tends to do). But small losses help you prevent big losses. Funds can be repurchased, and if you're so enamored of this one investment, keep it on your radar screen and perhaps get it back later when it has stabilized. Everyone makes mistakes when they invest—I left my money in the stock market much longer than I should have amid the meltdown in 2008—but keeping those mistakes small will preserve your capital.

First, though, we have to start with the deprogramming. In the 1960s Timothy Leary exhorted a generation to "Turn On, Tune In, Drop Out." I'm not suggesting anything so drastic as to remove yourself from the market entirely. But there's a lot of noise that can be filtered from your daily diet, and it starts with most forms of media, but particularly the television. So we're going to drop out. That means it's time to turn off the racket that is CNBC and the ongoing clamor of upgrades, downgrades, and smugness that makes up the bulk of that station's programming. Most of the station's commentary—other than finance guru Suze Orman—isn't helpful for long-term investment strategy and really only serves to amplify conventional market wisdom and heighten your sense of insecurity. Get shut of it. You need to start with that much. Your retirement does not depend on the next round of corporate earnings or the monthly report on the Federal Reserve's Philadelphia-region business activity index.

From there, it's time to start ignoring the investing blogs that constantly advise shifting from one position to the next, and particularly to leave behind the rumors and stock-touting that make up the bulk of investing discussion boards. This isn't to denigrate blogs: I wrote one for three years covering the ups and downs of the market on a daily basis, and there are many terrific individuals out there watching the

market and writing interesting things in the blog format. Many of them, because they're concentrated on one thing, are particularly astute. But consider them the way you consider your favorite sports columnist—something to enjoy without having to follow to the letter.

There are also those (and this is especially true of message boards) that don't go much further than being a tout service. Furthermore, you can go and chuck into the trashcan every magazine telling you about "the best funds to buy now" and can every weekly or daily newspaper yammering on the newest strategy designed to avoid all of the pitfalls that they somehow didn't manage to pick up on when they were advising you to buy the last fad—the one that led the market into the toilet when stocks tanked just a few years ago.

It was this advice that gave birth to the main idea of this book. In a busy daily routine that involves holding down a job, caring for children, maintaining a house, and myriad other responsibilities that many of you have, it's hard to find time for anything. And as a result it requires triage: You have to worry about your money, but the requisite amount of time you need to truly keep track of individual shares is more than a person with a full schedule can bear. You've got to take care of medical expenses, funding your retirement, education for your children, making sure bills are paid, mortgages are taken care of, and taxes are accounted for, in addition to putting your money away in investments that are properly diversified in a number of areas. Within that investment portfolio you have to diversify between stocks, bonds, cash, and a number of other asset classes we'll get at later—and keep track of when it's time to rebalance your portfolio. With all of this in mind, something has to give—and the research into positions on individual shares is a prime candidate, and so are the costs associated with trading and paying for active management that already put you three lengths behind the field before the starting gun has been fired.

Now I know you're probably wondering, is it possible to still put together a portfolio that does well without buying individual stocks?

Most assuredly it is, but it comes from paying attention to your costs, making sure you don't forget about your investments for months on end, and understanding what you need to retire with the kind of life you want. That's plenty of work to do without delving into individual names, particularly when most professionals are already pretty poor at trying to outdo the major market averages in the first place.

And that's another point to consider: There's an argument that simply investing a lot of your money in index funds (which is in part what this book advocates) means you're going to underperform the market no matter what, but I think that's the wrong parameter to begin with. After all, major indexes are representative only of themselves: the Standard & Poor's 500-stock index may rise a certain percentage in a given year and may be averaging 7 or 8 percent per year for the last 30, but if you only need 5 percent a year, the S&P 500 is meaningless. If you need 10 percent, it's just as meaningless—it's only a guide to itself. The goal isn't necessarily going to be to hit the market's average for a number of years, but to garner strong enough returns that will allow you to live as you want in your retirement. If you can do this with nothing but the carried interest from government bonds because you already have a massive nest egg, then good for you—you have little reason to invest in riskier assets. If you're struggling to fund a retirement, the reality is that you're going to have to take more risks. This is all the more reason, however, to keep costs low, so you're spending less of your capital on overhead.

This book is not designed to be defeatist. It's meant to help navigate through tumultuous markets, which we're bound to see more of in the coming years, and also to try to shift away from the reflexive notion that stocks are all that matter when it comes to putting together a portfolio.

Stocks for the Long Run...Or Not

The ascendance of equities as the most important investment in one's portfolio ahead of all else (particularly as many were lobbying to find ways to invest Social Security payments in the stock market) coincided with the underperformance of that very asset class against more conservative investments. An investor who elected, in 1969, to invest in the bond market rather than stocks would have likely outperformed the stock market. According to Chicago-based research firm Ibbotson & Associates, long-term government bonds returned, on average, a compound annualized total return of 8.79 percent since 1969, beating the Standard & Poor's 500-stock index, which gained 8.70 percent in that time. That difference in performance is not dramatic, but it is notable considering the safety of government bonds with the riskier stock market.

What stands out amid the performance of stocks and bonds is that the former remains much more volatile than the latter. Both the bond and stock markets have had great years—the best year for stocks since 1969 was in 1975, when the market rose by 37 percent, and bonds nearly equaled that feat in 1982, gaining 36 percent. On the other hand, a bad year for bonds is 1999, when they fell 6 percent. But stocks are like the proverbial little girl with the little curl in her forehead: When they're good, they're very very good, but when they're bad, they're horrid. In 2008, the S&P fell 37 percent, and many individual names did worse.

Slicing and dicing those figures further brings better results for bonds in some cases, and more favorable outcomes for stocks in others. Government bonds easily beat stocks for the 20-year period beginning in April 1989, returning 9.61 percent, compared with a 7.42 percent gain for the S&P 500. Intermediate-term bond funds (which concentrated on buying bonds that mature in two to seven years) pull in a return of 7.39 percent, just behind the stock index. Stocks do better if

the starting point is placed in 1979—a 10.3 percent return compared with a 9.93 percent return for bonds—and of course when the last ten years are considered bonds wipe the floor with the stock market.

The choice between bonds and stocks does tilt in favor of stocks over much longer periods of time. Ibbotson notes that the S&P 500 produced a compound annual average return of 9.44 percent between January 1926 and March 2009, whereas bonds, in that period of time, returned 5.6 percent annually. And Wharton professor Jeremy Siegel used historic data beginning in 1802 to argue for the superiority of equity market returns.

However, those early figures have been challenged by a number of analysts as spotty, relying on just a few stocks to serve as the benchmark for 19th-century figures and overstating the dividend component; others believe the long-run return of stocks is perhaps closer to 7 percent or even 5 percent, as the classic tome *Triumph of the Optimists* points out.

Market mavens hold this kind of history up as a sign that it's folly to consider the bond market as a potentially superior investment. Then again, there are very few people who started investing in 1926 and 83 years later, were still saving for retirement, other than perhaps 900-year-old Jedi master Yoda and Jeanne Calment, the French woman who died in 1997 at the age of 122.

Some would argue that the stock market has not really had a long enough period for one to analyze whether it indeed is truly an outperformer. The S&P 500 has only been around since the 1920s. Historical looks at stocks show that over 200 years, stocks have beaten bonds by about two percentage points, but Rob Arnott, chairman of money manager Research Affiliates, noted to the *Wall Street Journal*[5] that half of that two-point outperformance in stocks comes from the 1949 to 1965 period, when stocks enjoyed a historic run, brought on by the post-war growth period in the U.S.

Notably, this sharp run-up came after nearly two decades of poor performance amid the Great Depression, the original event that turned investors off of equities for decades. Without that post-war period, stocks beat bonds over 200 years by one measly percentage point, and with that one point you get a heck of a lot more volatility and substantial additional risk.

This long-term performance makes investor willingness to place greater hope in the stock market puzzling. Perhaps the desire to invest in stocks comes from the dangling possibilities of riches that an investment in a staid government bond cannot promise. A person buys a bond in the knowledge that he will get his money back, with a steady interest payment. A person buys a stock hoping she's stumbled upon the next Google—which tripled between 2005 and 2007.

Perhaps the psychological preference to stocks comes from the desire for getting the most for as little as possible, or the hope for something bigger and better, which is what equity markets promise. The stock market gets at the very heart of the optimism that is part of human nature. Bonds? Bonds are like eating vegetables.

Investors in stocks are essentially telling the company in question, "Here. Here's my money. Good luck. Hopefully, this will all work out for all of us."

Now, they can point to historical figures, such as steady earnings, past performance of the stock and related companies, or economic growth, for justification of their investment in the unknown. But really, there are only two ways to make money in stocks: Payment of dividends, or later sales of the stock in question at a higher price. These two methods hearken to the two major theories of stock investment—the firm foundation theory and the castle-in-the-sky theory. The former is based on the premise that stocks have an intrinsic value that is a discount on their future earnings and dividends and are valued based on that—investing in a stock that is undervalued will produce steady returns over long periods of time. The latter describes

the market's psyche of the last two decades, namely that it does not matter what you think of a company's intrinsic value, it only matters that someone else thinks it is worth more. It calls to mind the old saw about two people being chased in the woods by a bear. One of the men expresses doubt that they can outrun the bear, and his friend replies: "I don't have to outrun the bear. I only have to outrun you." Investing since the run-up in the mid-to-late 1990s has been a repeated application of the "greater fool" theory, where one only needs to find another willing investor to buy stuff, another person who cannot outrun the bear.

In the realm of the stock market, many investors employ dividend-seeking strategies, and base their decisions on the companies paying the heftiest dividends back to investors as a percentage of the stock price, which is referred to as the "dividend yield."

For example, say a company priced at $10 a share is paying a $1 dividend per year. When one buys that stock, the investor is guaranteeing themselves at least a 10 percent return—$1 for every $10 spent. If, for instance, the S&P 500's overall dividend yield is about 5 percent, and government bond yields are hovering around 3.5 percent, the decision to buy stocks becomes easier.

But many companies do not pay dividends, and in 2008 and 2009, many have eliminated or curtailed such payments due to the market's problems. (This will reverse in time, though.)

That leaves the second way to make money in stocks—through sales of the shares to someone else. But this relies on expectations that someone else will—based on a company's earnings, cash, assets and other indications—value the company at a higher price than you did. If dividends aren't part of the picture, this is basically a mathematically inclined form of gambling, where an investor hopes someone else will appraise their stock at a higher price than the last person. Yes, many will argue that stocks will appreciate over time based on those expectations for greater growth and steady earnings,

and in many cases, this is how it works out. But intrinsically there's still a bet that the other guy is going to look at a particular stock and agree to buy it at a higher price than you did. It depends on an ongoing supply of new investors who believe the investment in question is worth more than the last guy. Don't believe me? Look to James Cramer, the hard-to-miss TV personality who ran (at its peak) the $450 million Cramer Berkowitz hedge fund. In his 2005 book, *Real Money*, Cramer also argued that the stock market had more in common with gambling than almost anything else, even advocating horse-racing guides as a valuable bit of reading for investors.

The argument in favor of buying because of expectations for greater growth is that the economy continues to grow, and companies continue to make more money, which justifies a stock being worth more over the years. And one would think that the traditional measures of valuation—price-to-earnings ratios, earnings growth expectations—would help investors guard against buying stocks when they reach levels that would be considered overvalued. If the market was truly efficient and was able to constantly adjust prices to reflect the true value of an enterprise, this kind of discussion wouldn't need to take place at all.

But in the last several years, the market has become more of a feeding frenzy. On average, investors hold stocks for much shorter periods of time than in the past, as more try to take advantage of buying interest based on unrealistic expectations—which adds to the Ponzi-scheme element of the market. It seems there's no shortage of reasoning (or rationalization, if you prefer) for buying stocks when they reach levels that should nominally be considered too expensive based on history, as long as someone else is buying them.

To say that stocks are a de facto Ponzi scheme is overstating matters—after all, companies that return dividends are giving investors back something for their money, and that dividend comes from earnings. It's not fake. But contrary to the popular disclaimer that "past performance is not a guarantee of future success," most investors rely

simply on that. Or as current Credit Suisse strategist Doug Cliggott put it in 1999, "the 'greater fool' theory has been around a long time."[6]

Legions of investors built fortunes (and later lost them) asserting that the Internet would increase productivity, thus obviating all of the old reasons for traditional ways of valuing investments. As a result, the Nasdaq Composite Index, an index heavily concentrated in technology stocks, exploded in the late 1990s. It reached 3000 on November 3, 1999, for the first time, and hit 4000—a 33 percent gain—just two months later. But it wasn't done! The 5000 level was hit in early March.

Convoluted rationalizations led a pair of authors, James K. Glassman and Kevin Hassett, to declare that the popular Dow Jones Industrial Average should reach 36,000 within a few years. This book was published in 1999. This prediction has not turned out so well. Stocks peaked in 2000, and then entered a corrective phase that continues to this day, despite hitting a new high in October 2007. The prediction seemed ridiculous from the outset and has since become the object of scorn, similar to Irving Fisher's assertion in 1929 that stocks had reached a "permanently high plateau."

Those who argue that stocks maintain a superior advantage over equities also can be guilty of looking too closely at U.S. stocks. The world's third largest economy is Japan. That country underwent a boom fueled by excessive speculation in real estate that at one point famously valued the Imperial Palace in Tokyo at more than all of the real estate in California. The country's primary stock market index, the Nikkei, peaked at the end of 1989 at nearly 39,000. Two decades later, the Nikkei trades at about 10,000, or about one-fourth of that market's peak, as the country spent more than a decade trying to pull its banks out of the rubble of the post-boom crisis. Such a situation persists in the United States, where major financial institutions have elected to keep credit tight for fear of more losses.

Bonds, by contrast, are a much more conservative investment, germinating from a more cautious rationale. The investment is a loan, not a prayer. Guarantees of yearly payments are given in return, along with the eventual repayment of the original loan. They're not risk-free, of course: Bonds issued by companies in poor financial shape are more likely to go bankrupt, or default on their debt, and as such merit a higher interest rate. (Government bonds generally do not default, unless they're issued by a government like Argentina or Ecuador, both of whom have reneged on debt payments in recent years.) U.S. government bonds are not in such shape, thanks to your tax dollars.

Not everyone is convinced bonds can continue to outperform the market, noting the unimaginably high inflation of the 1970s and the subsequent decline in those rates as crucial to the bond market's stellar returns of the last four decades. This is unlikely to be repeated, and if it is, it would first require massive rises in bond yields—and therefore, sharp losses in the value of those bonds. "Bond returns were not only much higher than their historical averages, but also higher than their current yields," noted Peng Chen and Roger Ibbotson of Ibbotson and Associates, on Morningstar.com's Web site.[7] They argue that stocks are more likely to outperform in coming years.

The more reductive thinkers in the crowd would look at the steady growth in the bond market and assume that stocks "have to" perform better, in the same way investors expected that the Internet stocks that once reached $150 a share "had to" return to something close to that level. (It's the kind of thinking that assumes a baseball player is "due" to get a hit after going hitless in his previous 14 at-bats—the chances do not change because of previous outcomes.)

Still, those who believe stocks will rebound may yet be right. As we will see, this still does not necessarily mean investors should default to the decades-old recommendation of 60 percent of one's investments in stocks and 40 percent in bonds. It also does not mean

investors should try their hand at beating the market through day-trading or active stock market investment.

Stocks indeed can produce strong returns through certain periods of time, and tend to do well after a period of underperformance such as the one that was experienced between 1999 and 2009. But investors can do plenty of damage if they concentrate their funds in all of the wrong stocks, as many found out through the carnage of the past ten years of investing.

Some of you may be looking at this book and thinking a similar thought as many more than likely felt about those tomes that rode the 1999 boom and confidently predicted the market would soar another 30,000 percent in the next week or what have you—that it's just taking advantage of the current bearish trend in stocks, and it's guaranteed to be proven wrong as the market soars in the next few years. But that's not the idea. What I'm trying to do with this book is let people know that:

1. There are options outside of merely accepting that one's money has to be in stocks to gain any kind of real solid return in coming years.
2. It is okay to sell from time to time—not willy-nilly, but you needn't ascribe to some vague notion of putting all of your money away and forgetting about it for 40 years until—voila!—you have enough for retirement.
3. More importantly, it's to allow people to admit that it's okay if they're not adept in buying individual names, that they can ignore "buying on the dips," or "going bargain hunting." It's not a deficit of character to not want to do this. Feeling this way has ruined many a portfolio as you succumb to envy of what the guy next door is doing, as he confidently regales you with tales of his investing prowess. Never mind all that. When the market does badly, he probably does worse.

You can hang in there by limiting your costs and not buying into the game that Wall Street investment houses, brokerages, advertisers, and the popular media has been selling for the last three decades. You can ignore the hype, the carefully constructed ad campaigns that, contrary to what they say, do not make a person feel empowered but make them feel anxious and inadequate for not following the herd. It's true that stock picking is a talent, which we'll demonstrate in coming pages. But it's a talent that most so-called professionals don't even possess, so you needn't feel bad that you don't have it either. What you can do is know where your money is going and make smart decisions but also as few decisions as possible, instead of going down the rabbit hole of constantly trading stocks.

Again, that's not to say that this book has some kind of magic elixir that will beat the market. If that's why you're holding this, I suggest you put it down and go find something else to read. This book is supposed to wake people up.

This book will show how index funds, over long periods of time, can generally get the job done. But this isn't some kind of ode to the joys of indexing, not when holding an index fund over the last decade has been akin to running on a gerbil wheel. This book also looks at how some prominent investors are finding ways to diversify and beat the market with targeted bets on asset classes rather than on sectors, and how a bit of work—through rebalancing, through holdings of bonds, through discipline and understanding emotions—can make you a lot happier in the coming years.

Again, that's not a secret formula. Being in my profession, I know better than to promise the world, or better returns than the next guy's great formula. There are lots of formulas out there; some of them seem to work, and some of them, as I'll demonstrate, are exposed as unworkable.

Going Forward

Over a long period of time it is true that stocks will tend to outperform the bond market, to say nothing of cash and certain other investments. But that period of time can be so long as to be irrelevant to the greater investing public, which tends to spend about 40 years in prime investing years. Someone who starts to build a nest egg at the age of 25 could have been lucky enough to do so in 1955, withdrawing their funds from equities in the late 1990s to shift to a recommended fixed-income portfolio, and absolutely rocked the long-term averages. But a person who started at age 25 in the mid-1990s got to see tremendous gains before it all went south and has since been treading water for ten years. Some 25-year periods have better annual average returns than others, and yet the person who ended her 25-year investing period with a substantial bear market ended up with less than someone else fortuitous to cap off two-and-a-half decades with a strong bull market.

Shopworn adages should not be construed as investment advice. There are times when buying and holding stocks is the best possible idea, and there are times when buying on pullbacks works like a charm. And there are also instances when both strategies will prove endlessly frustrating.

Not only are individual investors poor at timing the market, there are plenty of professionals that are just as bad. In fact, most of them are pretty bad, and the ones who are good aren't selling their advice to the public.

There's a lot to discuss about the vagaries of the stock market, but if we're going to continue on this journey of waking up, before we even discuss individual stocks, stock sectors, and stock indexes, we have some more deprogramming to do. I've already mentioned the need to turn off the television and close the magazines, but we need to look a little bit more at that. Then we're going to talk about what to do with your emotions and how you can best understand them so they

play a key—but not overwhelming—role in your decision-making processes. First, let's look back at some of the worst prognostications of the last several decades, the ones that formed the basis of thought for many magazine subscribers in the last decade.

Boiling It Down

- Don't go down the rabbit hole of constantly buying individual stocks or day-trading. You probably don't have the time or the expertise. Stick with index funds and ETFs.
- If you must buy stocks, don't buy stocks and never sell them. If a stock is a long-term dog, sell it. The same goes for ETFs or other assets.
- You can't just forget about your stocks or any of your investments for months on end.
- Keep your costs low. Stay away from high-priced funds and watch out for big fees on investments.
- Simply investing 60 percent of your money in stocks and 40 percent in bonds is not enough diversification.
- Rebalancing your assets on a regular basis, holding bonds, and understanding your emotions will make you a better investor.
- Understand how much money you will need to retire.

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