

Lies And Other Fallacies

While driving through Phoenix, I saw a billboard asserting that wealth could be attained by engaging in a potentially addictive and self-destructive behavior --

Easy Street It's Only A Play Away Casino Arizona

The marketing team that came up with this slogan must have checked their collective consciences at the door. Unfortunately, not all fallacies are this easy to spot and much of what passes for investment advice these days is just a subtle variation on this theme.

One fallacy asserts that you can find a shortcut to Easy Street by investing in the next miracle stock, hedge fund, computerized trading scheme or by becoming a disciple of a market timing guru. But the best route to Easy Street is to live within your means and save and invest in a disciplined manner. Consider a 25-year-old who can save \$1,000 per month in a 401(k). At a growth rate of 8%, our investor would have an inflation-adjusted \$1.1 million at age 65. Not too shabby. The simplest portfolio imaginable -- 50% S&P 500 Index and 50% long-term US government bonds yielded an 8.4% average rate of return from 1926 through 2008. Surprisingly, eliminating the government bonds and changing the allocation to 100% S&P 500 Index would have increased the annual rate of return by only 1.2% and doubled portfolio volatility. Not a good trade-off in my opinion. How else could our investor increase the size of his nest egg? It doesn't sound unreasonable to assume that by becoming a market timer or stock picker he could increase his rate of return. But studies show that the more that investors trade the less they make. A new study shows that the more investors *look* at their accounts the less they make. This makes sense. It is almost impossible to separate our emotions from our investment decisions. During those times when our account values are rising or declining rapidly our emotions will, more often than not, cause us to do the wrong thing at the worst time. A wiser tactic would be to increase the savings rate - which would guarantee a larger nest egg at retirement with no increase in volatility. Two important ingredients in this strategy are delayed gratification and spending discipline - which have always been harder to sell than the voodoo duo of market timing and stock picking.

Another fallacy currently in vogue is that when the stock market declines precipitously it is prudent to retreat into the safe haven of cash until things "settle down." Since remaining in cash is not an option for most people, those fleeing the market do so with the intention of getting back in "some day." It's always tempting to flee a declining stock market and wait for the bottom to be reached. But such a strategy has proven again and again to be flawed because it is virtually impossible to know what "settle down" will look like or when that "some day" will arrive. Wall Street will never send out an e-mail saying "Today's the day!" Initially, panicked sellers feel relief knowing that they will not experience further losses in the near term. However, that feeling of relief is soon replaced by two new fears - the fear of getting back in too soon (and feeling like a fool) and the fear of getting back in too late (and feeling like a fool). Buy and hold investors don't have such concerns. Whenever the market rebounds we will reap the full benefit. Historically the price recovery from a market bottom has often been swift. Market activity this past month has been almost unprecedented - this time in a good way. In the month after reaching its low on March 8, the S&P 500 Index has risen faster than at any time since 1933 - the year a young minor league baseball player named Joe DiMaggio set a Pacific Coast League record by hitting safely in 61 consecutive games. The financial media is all abuzz with the big question. Is this just a bear market rally or is it the start of a new bull market? I don't know and I don't care. No one else knows either but for market timers the answer to this unanswerable question is financial life and death. I'd rather read about Joe DiMaggio.

A common fallacy making the rounds today is that last year's market decline hurt index investors more than those using active management because we experienced the full brunt of the market's selloff. Standard & Poor's has just published an analysis of how well active managers did versus the major S&P indexes in the 5 years ending last December. The large-cap S&P 500 Index outperformed 69% of actively managed large-cap

mutual funds. The mid-cap S&P 400 Index outperformed 76% of actively managed mid-cap mutual funds. The small-cap S&P 600 Index outperformed 78% of actively managed small-cap mutual funds. The S&P Global 1200 Index outperformed 70% of actively managed global equity funds. S&P's bond indexes outperformed 75% of actively managed domestic bond funds -- including both bond funds in the United Airline pilot PDAP. Since the current bear market began in October of 2007, a majority of active managers in 7 of the 9 asset classes into which Morningstar divides the US stock market have underperformed their benchmark index. What explains investors' continuing fascination with active management? Most investors have no idea of the miserable track record of active managers. Wall Street is well aware that investors will happily pay invisible fees for the promise of market beating returns with less volatility. So rather than being dead and buried, active management continues on life support with no end in sight.

The biggest fallacy running around today is that "it's different this time." An artillery barrage of data that supposedly supports this fallacy has been shot our way by the media on a daily basis the past year or so. But being bombarded by information overload does not always produce wisdom and many investors have become terrified into paralysis. Perhaps some profound change has occurred in the economic and social scheme of things that makes history invalid. But I don't think so. What we have gone through is not unprecedented in degree; rather the decline in stock prices was unprecedented in swiftness. A single year of disappointing performance does not invalidate strategies that have been successful in the past. It's common today to hear that stocks have "done nothing for the past 10 years" and bonds are now the investment du jour. For the past 80 years, large company US stocks have returned 6.6% more than inflation and small company US stocks - because they are riskier investments - have returned 8.6% more than inflation. Bonds have not fared as well. Long term government bonds have returned 2.7% more than inflation and long-term corporate bonds (which have slightly greater risk because of the possibility of default) have returned 2.9% more than inflation. I believe that the future long term return on domestic stocks and bonds will follow this general relationship and that, after inflation, the stock portion of your portfolio will yield 2 - 2 ½ times the return of the bond portion. The details of history constantly change but I'd rather base my investment strategy on the lessons of history not the opinion of somebody with access to a microphone and TV camera. Our economy is very strong and resilient and it has never been profitable to bet against it in the long term.

I suppose that anyone who perpetrated a \$50 billion Ponzi scheme could be considered the greatest liar of all time - at least in the financial world. But to those who were paying close attention, Bernie Madoff may have spoken words of truth in his court appearance that, if heeded, will save future investors a multiple of \$50 billion. Like most people, I thought that Madoff originally tried a trading scheme that failed. Rather than admit his failure, he turned his operation into a Ponzi scheme. But in his statement to the court, he admitted that it was a Ponzi scheme from day one. He then went on to say -

I had received investment commitments from certain institutional clients and understood that those clients, like all professional investors, expected to see their investments out-perform the market. While I never promised a specific rate of return to any client, I felt compelled to satisfy my clients' expectations, at any cost. I therefore claimed that I employed an investment strategy I had developed, called a "split strike conversion strategy," to falsely give the appearance to clients that I had achieved the results I believed they expected.

Rather than turn away their money, Madoff promised clients market beating returns that he knew he could never deliver. All it cost him was his soul.

Hot on the heels of the Madoff scandal, a pernicious new fallacy has been birthed in the financial community. It is being spread through articles in trade publications, seminars and lectures by prominent money managers and advisors. It attempts to answer the question that all advisors have been asking -- "What could I have done to protect my clients from the investment misery of the past year?" Apparently the correct answer - nothing - is not acceptable. We are being told that a buy and hold strategy and index investing died in the 20th-century. The 21st-century advisor must be able to predict the future - why else would clients hire us? We are being advised to pay closer attention to the events in today's news. We are being encouraged to engage in the academically discredited madness of technical analysis -- gazing intensely at charts and graphs of past market activity to divine from these scribbles insights into the future. We must put client money into new and exciting, though incomprehensively complex, investment products. We are being told that traditional portfolios consisting of stocks, bonds and real estate are deficient. Successful advisors in the 21st century must be proponents of managed futures trading, hedge funds, currency plays, divining the political tea leaves, taking advantage of market trends, sniffing inflation before it arrives, ad infinitum ad nauseam. Not surprisingly, many investment products and funds are being marketed by the speakers and authors themselves. One proponent of this drivel is the well respected Bill Gross, co-founder of Pacific Investment

Management and manager of the largest bond fund - the PIMCO Total Return Bond fund. Now I don't doubt that Mr. Gross is 10 times smarter than I am, but after expenses his fund has underperformed its benchmark Aggregate Bond Index in the last 1, 3, 5 and 10-year periods. He is also one of the two managers of the United PDAP diversified bond fund - which has underperformed the Aggregate Bond Index in the past 1, 3, 5, and 10 year periods. Do as I say, not as I do? No thanks Bill.

I'm afraid that misguided financial advisors, who should know better, are buying into this idiocy. I've met many brokers and financial planners. Most are hard working and have their clients' best interest at heart. And I can assure you that there is no chance that they can successfully reincarnate themselves as market prognosticators. Not today, not tomorrow, not ever. They are being encouraged to do what the Chairman of the Federal Reserve can't do, what the Treasury Secretary of the United States can't do, and what the smartest minds on Wall Street can't do. Trying to justify their fees by investing clients' money according to their own speculations about the future is lunacy of the highest order. The future is a cosmos of uncertainty populated by black swans. Advisors who make radical changes to client portfolios based on their own personal hunches are not providing a service to their clients; they are providing a disservice to them.

2008 did not teach us that buy and hold doesn't work, that diversification doesn't work, that international investing doesn't work, that index investing doesn't work, or that stock investing is too risky. The lesson of 2008 is that markets are unpredictable and more volatile than we'd like. The long-term average return of the stock market hides many periods of unpredictable short-term volatility. It's market timing and stock picking that cannot work. Forget the endless reams of academic data that show market timing and stock picking haven't worked; it should be intuitively obvious that they can never work. It is *unexpected* news that moves markets. And by definition, unexpected news is unknowable in advance -- by anyone.

The 21st-century advisor must provide clients a strategy that encompasses a long-term holding period for stocks, conservative return expectations and proper diversification to maximize the odds for investment success. Hunches have no place in financial planning. Don't let anyone fool you into thinking that they have a clear vision of tomorrow. Market timing is a gamble, Wall Street's version of what goes on in Casino Arizona.

Missed By That Much

Wouldn't it be great if a few years ago we could have invested our money with a true market seer -- someone who saw this financial mess on the horizon and went to a large cash position before the walls came tumbling down? An article in *The Wall Street Journal* tells the story of a mutual fund manager who did just that. Robert Rodriguez, manager of the FPA Capital fund warned in 2005 of "financial strains" at Fannie Mae, Freddie Mac and AIG. In a speech in June 2007 he said that housing, stock, bond, private equity and hedge fund markets were caught up in a speculative bubble and he predicted a recession in 2008. In December of 2007, he stated his belief that a credit crisis would lead to a severe recession.

How did the FPA Capital fund do in 2008? It declined 35% despite its large cash position. Despite his astute calls and avoidance of financial stocks, Mr. Rodriguez was heavily invested in energy exploring companies as well as Circuit City stores - now in bankruptcy. Throughout the fourth quarter of 2008 he increased his exposure to energy related companies but their stock prices continued to decline with the bursting commodities bubble. Despite a disappointing 2008, FPA capital has outperformed the S&P 500 Index for the past 10 years. Unfortunately, its recent poor performance has caused shareholders to withdraw over \$1 billion from his fund in the past two years. When you sell performance, investors don't hang around very long if you disappoint them.

Market timing is a gamble, no matter how you cut it. When someone gambles and wins, we don't consider the gambler a genius -- we call him lucky. But if the same person takes a gamble and loses we think -- what a fool. Despite making an astute call and exiting the market before last year's big decline, Mr. Rodriguez re-entered the market too soon and bought stocks that continued to decline in price. So, the problem of active management isn't just seeing the big picture of the future but also deciphering the small details that are hidden behind the cracks deep inside your crystal ball.

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