PART I

Outperforming the Market

CHAPTER 1

Modern Portfolio Theory

People invest money in the stock market with one primary goal in mind: to earn a satisfactory return on that investment. Some consider investing to be a full-time occupation with the goal of earning enough to provide for their day-to-day living expenses on a continuing basis. Some will be retiring soon and must plan to begin using their investment nest egg to meet expenses. Others have a much longer time horizon and are planning 30 or 40 years into the future.

With such a variety of time frames and purposes, there is no single investment strategy that suits all investors. There is no single "best" portfolio of investments to own.

INDIVIDUAL INVESTORS

Many individual investors decide for themselves which specific stocks to own. Whether the buying decision is based on sound research into the fundamentals, including a thorough reading of the various financial reports issued by the company, or whether price history charts are studied in an effort to perform a thorough technical analysis, or whether an investment decision is based on a tip received from a stockbroker, bartender, chat room, or a talking head on CNBC or *Wall Street Week*, investors seldom consider their entire portfolio when making a new purchase. The buying decision is often based on investors' belief (hope) that some information has been uncovered—information not yet known to other investors—that will soon make the price of the newly purchased stock soar.

Some investors make investment decisions alone, shunning the advice of others. Some rely on the camaraderie of an investment club. Some listen to the advice of professionals before making the final decisions themselves. Some blindly follow the advice of a stock market advisory newsletter while others do everything their stockbrokers suggest. Regardless of the source of an investment idea, most individual investors never think twice about whether the new investment is suitable or whether it helps them achieve their overall investment goals. In fact, many have no overall objectives in mind and simply make new purchases to produce a portfolio based on chaos. Some investors are happy with their results, while others are not. Modern portfolio theory (MPT) teaches us that this is a poor way to invest. With so many investors accumulating stocks and building a portfolio in this haphazard manner, it's important to know: Are individual investors generally successful? The answer to this question is postponed until Chapter 2.

Investing in Mutual Funds

Many millions of other investors don't want to take the time or make the effort to choose their own stocks. Instead, they rely on financial professionals to make investment decisions for them. Some of these investors follow the advice of a guru who sells stock market advice for a fee (e.g., newsletters and advisory services), while others accept the investment advice of financial planners or stockbrokers. But the vast majority of these investors buy shares of mutual funds.

Mutual funds serve a great purpose. They allow investors to quickly own a diversified portfolio of stocks without being required to buy shares in each of the individual companies. This is especially important for small investors who lack the funds to own a properly diversified portfolio of stocks. It has been known for a long time that proper diversification is a strategy that reduces the risk of investing in the stock market. It's one of the cornerstones of MPT.

Having decided to buy shares of mutual funds, investors must rely on the ability of fund managers to make intelligent investment decisions and earn a good return on investor capital. Some investors make a careful study of mutual funds before selecting which to buy. They study how well mutual funds have performed in the past; they check out Morningstar's[1] rating on the funds, or they accept the advice of a stockbroker.[2] Some investors go further and choose funds that invest in the type of stocks they want to own. For example, some funds only buy stocks of large companies; others specialize by investing in smaller, growing companies. Some funds buy stocks for income (dividends); others buy stock for long-term growth. Some funds specialize in the companies in one specific industry (sector funds); others are more diversified. Some buy stocks in American companies; others invest in businesses from around the world. There are many mutual funds in existence, each with its own investment strategy, and the public investor can choose any of them.

Some who buy shares of mutual funds invest their money, close their eyes, and, placing their trust in the fund's managers, hope for the best. Others take the opposite approach and constantly monitor the performance of their funds and hop from one fund to another, chasing those with the best recent performance.

Most of those who invest in mutual funds would be better served if they had an understanding of how to construct a safer and better-performing investment portfolio on their own. Our goal is to show you, the individual investor, how to do just that.

Some investors are sophisticated enough to know how to avoid paying a sales commission (load) when buying funds; others pay that load, not knowing there is any alternative. The bottom line for the vast majority of mutual fund investors is that once the decision to buy a fund is made, no further thought goes into the process. They leave it to the fund management team to produce superior returns on their money. Over the years, most investors have been satisfied with this methodology, especially since the trend of the American stock market has been bullish over the long term.[3] With so many Americans relying on mutual funds to meet their investment objectives, two important questions must be considered: Are mutual fund investors generally successful? Are they well served by the managers of those funds? Let's postpone a discussion of the answer until Chapter 5.

MODERN PORTFOLIO THEORY

Investors seldom, if ever, consider their entire portfolio as anything but a collection of individual investments, regardless of whether those investments are individual stocks, mutual funds, or any of numerous other assets, such as bank certificates of deposit, bonds, or coin collections. Few consider whether adding a new investment to a portfolio affects the overall risk parameters of the portfolio, or whether it helps to diversify their holdings. Usually asset allocation is totally ignored. This is not a good thing.

There exists a large body of knowledge that has collectively become known as modern portfolio theory. MPT tells us that investors can successfully (and easily) use a scientific approach to compile an investment portfolio. It's worthwhile to make a brief study of this collection of knowledge because it contains ideas you can easily adopt to make your own investing more efficient and more profitable. One of the great benefits of

MPT is that it shows how to increase the expected profits *and* lower overall risk at the same time

MPT is concerned with the methods used to compile an investment portfolio and with the performance of that portfolio. Investors can easily earn the risk-free rate of return by purchasing U.S. Treasury bills.[4] But to earn more, investors must accept the fact that a certain amount of risk must be accepted. It's generally understood in the investment world that the greater the risk of an investment, the greater the potential reward. This must be true, or else no one would ever knowingly accept greater risk. It's important to point out that the term "risk" is usually considered to represent the chances of losing money from an investment. According to MPT, risk is much more than that; it's also a measure of how much the return on an investment varies from the expected return. Thus, risk is a measure of the uncertainly of the future.

The work of Harry M. Markowitz changed the way investment managers think, when he demonstrated that including certain classes of assets in a portfolio influenced not only the profit potential of that portfolio, but also its volatility, or the rate at which the value of a portfolio fluctuates.[5] The major conclusion of MPT that concerns our discussion is how to construct an investment portfolio that aims for higher profits with reduced risk.

Markowitz did the original work in this field, and others have made significant contributions.[6] Among those are Professors Sharpe, Cootner and Fama.[7] A good discussion of MPT can be found in the text authored by Rudd and Clasing.[8] The theory is not some obscure topic of interest only to academics, but is widely used in today's investment universe. Markowitz and Sharpe shared the Nobel Prize in economics in 1990 for their contributions to this field.[9]

The early development of MPT relied heavily on statistics, and the pioneering work is highly technical. Nevertheless, the basics of MPT can be explained in simple terms (the more complex math remains available for those readers interested in such details[10]). The discussion here is limited to explaining what MPT is, why it's important for today's investor to understand its basic teachings, and how you can easily build a portfolio based on its precepts.

Here is a simple summary of how MPT describes the thought process behind investing:

> *An investment is made in a security, or portfolio of securities, in anticipation of receiving a monetary reward. The expected reward is the average reward that results from holding the specific investment(s). Some years the return on the investment exceeds the expected return, and some years the return on the investment is less.*

The investment universe is filled with uncertainties, and, therefore, there is a certain degree of risk encountered when attempting to collect the reward. The risk is a measure of the uncertainty of earning the expected return.

Thus (states the theory), an investor chooses among investment possibilities based entirely on the two measures of risk and reward, attempting to minimize the former and maximize the latter.

ASSET ALLOCATION AND ITS ROLE IN MODERN PORTFOLIO THEORY

What does MPT tell an investor about how to choose the components of a portfolio? The first idea is to diversify one's holdings and to allocate part of the investment capital among several asset classes. Reasonably enough, this strategy is known as asset allocation. Not so many years ago, asset allocation meant owning a variety of stocks and bonds and some cash equivalents. The prudent man rule reinforced this type of thinking among fiduciaries, or those responsible for investing other people's money.[11] Today MPT goes further and focuses on the portfolio as a whole, and not on its individual components. But proper diversification remains an essential ingredient of MPT.

When following MPT to build a portfolio, it's not sufficient to compile a portfolio simply by investing in different asset classes (e.g., stocks, bonds, gold, and real estate). MPT teaches that it's important to find the *optimal* allocation of assets satisfying both the investor's risk tolerance and reward (expected rate of return). It's important to own a variety of investments that perform differently in the marketplace. In other words, there should be minimal correlation in the performance of each individual investment with each of the other investments. If it sounds difficult to build a portfolio one stock at a time that satisfies these parameters, especially for an individual public investor, be assured that it is indeed difficult. But don't fret, as there is an easy method to accomplish this goal for the portion of your investment capital that you allocate to the stock market. That method is the basis of this book. A well-qualified financial advisor ought to be able to help you achieve the type of portfolio recommended by MPT for any assets you own that are not stock market related.

Again, it's important to reiterate that our discussion focuses on only that portion of your assets you have allocated to investing in the stock markets of the world. This book makes no recommendation on how you should otherwise allocate your assets. MPT tells us that asset allocation should not be ignored, as it represents the best method of reducing the overall risk of your portfolio. Numerous books offer advice on how to allocate assets in accordance with MPT, and we'll leave that discussion to them.[12]

THE PRUDENT INVESTOR

The prudent man rule contains guidelines for those responsible for investing other people's money. The purpose of the rule is to offer protection to investors by providing those fiduciaries with investment guidelines. Over the years, the rule has changed with the times. At one point, it would have been considered lunacy to invest the savings of a public investor in the stock market. After World War II, as inflation became important in making financial decisions, it was considered extremely imprudent for a fiduciary *not* to invest in the market. Today it is not enough to merely invest in stocks, and the prudent man rule requires that fiduciaries invest at least part of an investor's funds via passive investing, using index funds. Passive investing is consistent with the teachings of MPT and represents an important part of our overall recommended investment strategy. It's the basis of further discussion in Chapter 2.

At one time, a fiduciary had the difficult responsibility of being certain that *each investment* was appropriate for an investor. Today, taking MPT into consideration, the prudent investor rule has been revised to "focus on the portfolio as a whole and the investment strategy on which it is based, rather than viewing a specific investment in isolation."[13] As a result, it's acceptable for fiduciaries to recommend shares that would be risky as standalone investments, as long as the entire portfolio is appropriate for the investor.

DIVERSIFICATION

Diversification is an essential element when following MPT. The easiest way for public investors to diversify has been to own shares of traditional mutual funds. Their very existence is one reason why so many Americans are currently stock market investors, as mutual funds make it easy for public investors to own a professionally managed diversified portfolio of stocks.[14] The wisdom of relying on these professional money managers is one of the subjects covered in MPT and this discussion is continued in Chapter 2.

CHAPTER 2

Can You Beat the Market? Should You Try?

The academics say, "No way." Professional money managers say, "We do it all the time." What's this argument about? It's a debate over whether anyone can build a portfolio of stocks that outperforms the market on a consistent basis. Academics claim the market's ups and downs are random and that it's not possible either to time the market[1] or predict which stocks are going to outperform the market in the future. Money managers claim the ability to do research and determine which stocks are undervalued and beat the market by buying those stocks. This is an ongoing disagreement with no end in sight.

Those who believe it's not possible to beat the market make this argument:

- Gross returns earned by investors as a group must equal the gross returns earned by the total stock market.
- Net returns—after advisory fees and other investment expenses—earned by investors as a group must fall short of the returns of the market by the amount of those costs.[2]

Those making this argument believe that simply hiring professional managers and paying fees for their services is enough to guarantee below-average returns over the long term. Their suggestion is to invest in index funds because those funds do not spend money on research and save money on commissions by owning and holding an investment portfolio. These funds charge much lower fees than traditional mutual funds, and those reduced fees enable index funds to come very close to matching the performance of the market (as measured by the index they are trying to mimic). This investment methodology is discussed further later in this chapter.

Those who believe in the efficient market theory believe that markets must be inefficient (information becomes available to different participants at different times) in order for any individuals to demonstrate the skills required to compile a portfolio of stocks that consistently generates above-average profits.[3] But, since they believe the market is efficient and all information that can possibly be known is already known, and that such information is already priced into the price of every stock, they believe no one has any special advantage and therefore no one can consistently outperform the market. Statistically there are always some who do outperform and others who underperform, but there is no way for an investor to know *in advance* who can generate above-average returns. Thus, efficient market theorists conclude, spending money in an attempt to outperform the market is a foolish endeavor.

Modern portfolio theory (MPT) agrees with the academics on this issue.

Most of the evidence tells us that markets are fairly efficient. As additional advances in information technology become available, the markets will become even more efficient. If that's true, then the question remains: With so much information available to everyone, and with sophisticated software available to analyze that information, is it possible for specific individuals to gain (and maintain) a sufficient advantage that allows them to build a portfolio that performs better than the portfolios of their peers? And if it can be done, is it reasonable for investors to spend time and effort in an attempt to find which funds to buy to benefit from that superior performance? In other words, can individual investors know which mutual funds are likely to do well in the future? Is past performance any indication of future results? Academia concludes that it cannot be done now, and in the future it will become even more unlikely that anyone can beat the market on a regular basis. The dispute goes on.

This author sides with the academic world and the teachings of MPT and believes that attempting to beat the market is an expensive, time-consuming, and fruitless endeavor for the vast majority of investors. As noted in the preface, most investors "feel" they can beat the market and attempt that feat year after year.

DO YOU STILL WANT TO CHOOSE YOUR OWN STOCKS WHEN INVESTING?

Do you believe that your stock-picking skills are excellent? Do you believe you have a trading system that allows you to do better than the market on a consistent basis? Do you believe technical analysis can tell you which stocks to buy and when? If you truthfully answered yes to any of the above, congratulations! You are already able to outperform the market and don't have to worry about diversification, risk reduction, or any part of modern portfolio theory. The lessons in this book are for everyone else, although you still can benefit by learning and adopting the options strategies taught in Part III and by learning to appreciate the advantages of diversification.

The question remains: Is there evidence on whether the average investor can beat the market by choosing individual stocks to buy and sell? Yes, there is and we'll take a look at the evidence later in this chapter.

WALL STREET SAYS YOU CAN BEAT THE MARKET

The professional brokers on Wall Street are in the business of trying to convince public investors that they easily can beat the market if they only would open a trading account with their brokerage house and follow their investment advice. But, to make money, individual investors must pick winning stocks, and, as you will see, the evidence tells us that the vast majority are unable to do it.

Managers of mutual funds take the same path in trying to convince investors to send them money. They often boast (via paid advertisements) of their recent market success. That advertising is effective, and investors rush to buy shares of mutual funds that recently have been able to beat the market.

RESEARCH SAYS YOU ARE UNLIKELY TO BEAT THE MARKET

Beating the market is a difficult task. With so many individual investors and so many professional money managers trying, the laws of probability tell us that some will be successful while others will not.

Some investors like to try to beat the market, especially if stock market investing is a hobby. By all means, enjoy yourself. But if your financial goal is to amass wealth over the years, and if your fun comes from success, then recognize that the odds are against those who try to beat the market on a regular basis. It's much easier (and more likely to be the winning strategy, according to modern portfolio theory) to own a suitable mix of ETFs. When

But I Can Beat the Market

If you still believe you have the ability to beat the market with your individual stock picks, don't stop reading. The strategy taught in this book works very well for investors who compile a portfolio of individual stocks, and gives you the information you need to enhance the return you earn on your investments—with the added bonus of doing so with reduced risk. Read on!

you modify your ETF strategy by adopting the methods taught in this book, your chances of enhancing your returns become even greater.[4]

If you still believe you can beat the market by selecting your own stocks, then you are certainly free to make the attempt. Just recognize the odds are not on your side. Owning a diversified portfolio of ETFs that meets the requirements of MPT can't be a bad thing. It *might* be possible to compile a portfolio by choosing individual stocks that gives you a slightly better than expected rate of return or a slightly lower level of risk, but there are two reasons not to attempt that feat: (1) It requires a great deal of research, and (2) it's not likely to make a significant difference. Professional money managers and individual investors have not been able to beat the market on a consistent basis,[5] and you will probably be better off spending your time deciding which EFTs are right for you.

If you are willing to consider the possibility that it's difficult, if not impossible, to outperform the market on a consistent basis, that doesn't mean you must sit back and do nothing. There are steps you can take to improve your performance. Asset allocation is the first step.

Once you have allocated a portion of your assets to the stock market, you can make additional modifications to standard investment methods that reduce your risk and raise your profit expectations. In this book, you will learn how to outperform the vast majority of investors who blindly buy mutual funds or who undertake the task of building their own portfolios one stock at a time.

WHAT IS INDEXING?

Let's begin our brief discussion on indexing with a definition. An index is a statistical representation of the performance of a hypothetical portfolio of stocks. That portfolio consists of each stock in the index, in its correct proportion.

When you choose the investment method of indexing, you are attempting to mimic the returns achieved by the market averages, rather than attempting to outperform those averages. Today many investors no longer feel it's appropriate to own shares of actively managed mutual funds—funds in which the managers frequently buy and sell stocks in an attempt to generate a higher return than competitive mutual funds. Indexers measure their performance against a benchmark, often the Standard & Poor's 500 index (considered by many to represent "the American stock market"[6]). More and more investors and fiduciaries are buying index funds and both the prudent man rule and MPT favor buying such funds. Public investors have come to accept owning investments that match the performance of the market averages, especially since those average returns were pretty spectacular during the bubble-building years of the late 1990s.[7]

BUILDING A PORTFOLIO TO MIMIC AN INDEX

An index fund is not hypothetical, but a real-world portfolio of stocks. The managers of the index fund attempt to mimic the performance of the index (and its hypothetical portfolio) as closely as possible. The best way to accomplish that task is to own the correct number of shares of each component of the index. For some indexes, that's a simple matter. For example, managing a fund that mimics the performance of the Dow Jones Industrial Average (DJIA) requires owning shares in only 30 different companies. Each stock is actively traded, and the shares are easy to buy or sell. Thus, when the managers of an index fund that mimics the performance of the DJIA receive cash from investors, it's a simple matter to invest those funds by buying the appropriate number of shares of each of the 30 stocks. Similarly, if there is an influx of redemptions (orders from shareholders to sell their holdings), the fund managers have no difficulty selling shares to raise cash to meet those redemptions.

However, some indexes consist of shares in a vast number of companies. For example, attempting to exactly replicate the performance of the Russell 3000 index or the Wilshire 5000 index is difficult. Each index contains thousands of stocks, and some are very thinly traded, meaning that only a relatively small number of shares trade every day. It is not efficient to trade those stocks frequently. When it becomes necessary to buy or sell a significant number of thinly traded shares, the fund managers easily could influence the price merely by attempting to buy or sell the shares.[8] Thus, it's a more efficient process to own a representative sampling of the stocks in such an index, rather that attempting to own each component. Fortunately, sampling is a viable strategy, and it's possible to compile a portfolio that produces investment results that are almost exactly the same as if the fund owned each of the stocks in the index.

If you ask why fund managers must buy or sell these thinly traded issues, consider what happens when the management team receives cash from investors. That cash must be invested (proportionately in each of the stocks that comprise the fund's portfolio) as soon as possible because holding a sizable cash position is not conducive to mimicking the market performance of an index. Holding uninvested cash runs the risk of underperforming in a rising market or outperforming in a declining market. Because matching the index is the managers' prime directive, they do not want to take the risk of timing the market. Neither beating nor underperforming the index is considered to be acceptable, but outperformance is always forgiven.

The managers constantly maintain a portfolio representative of the specific index they are trying to mimic and trade as infrequently as possible. This keeps expenses low. However, when a change in the composition of the index occurs (a new stock is added or an existing member of the index is removed, the portfolio must be adjusted accordingly.)[9]

When you buy shares of an index fund, you agree to accept a return on your investment that closely resembles the return of the overall market (or the market segment the fund is attempting to mimic). By saving management and execution fees, investors are ahead of the game.

Indexing is still a controversial topic and is likely to remain so for many years, but prudent investing favors indexing strategies. One recent book, *The Successful Investor Today*, gives an excellent summary (including additional references) that makes the case for accepting passive investing.[10] Other books on this topic also are available.[11]

The History of Indexing

The first index fund became available to public investors when Vanguard launched the First Index Investment Trust in August 1976. The fund's name has since been changed to Vanguard 500 Index Fund. The availability of such funds is important because MPT tells us that owning index funds is the best investment strategy for most public investors. Going even further, MPT teaches that each investor should own a suitable assortment of index funds, ensuring proper diversification. If you accept the argument that selecting individual stocks in an attempt to beat the market is not in your best interests, index funds represent an excellent investment vehicle, as they provide diversification accompanied by minimal management fees. For example, the Vanguard 500 Index Fund costs investors 18 cents per year, per $100 invested, compared with $1.25 per $100 investment for the average actively managed mutual fund.[12]

PASSIVE OR ACTIVE MANAGEMENT?

Portfolios can be managed passively or actively. The passive strategy, which is called indexing, involves building a portfolio that performs as closely as possible to the performance of a specific broad-based index, such as the S&P 500. Passive investing produces less stress for the investor, who no longer has to worry about the performance of the fund's management team. Of course, if the market undergoes a steep decline, the investor's portfolio loses value. For investors who want to be invested in the stock market, indexing is an excellent methodology, according to the teachings of MPT, as it provides a way to reduce risk through diversification. The passive portfolio manager exercises no judgment in building the portfolio, and no trading decisions are necessary. The most obvious benefit of this strategy is reduced expenses, as trading expenses are minimal and research expenses are eliminated. Indexing is becoming an increasingly popular investment choice.

The obvious disadvantage of passive investing is the inability to outperform the market. For some investors that's acceptable, as there is also the inability to underperform the market.

Managing traditional mutual funds is a hugely profitable business. Fund managers maintain those profit levels by charging their mutual funds (and thus, the fund's shareholders) much higher fees than they charge their institutional clients for identical services.[13] The managers of actively traded mutual funds are not going to sit quietly and give up their franchise to those who manage funds passively. These management companies spend huge sums on advertising, trying to convince the average public investor that investing with them is the smart thing to do. These managers always leave the impression they can beat the market averages in the future simply because they may have beaten them in the past.[14] The year's best-performing funds promote that performance, attempting to entice investors to place new money in their funds.

When running an actively managed fund, the managers not only choose which specific investments to own, but also use market timing strategies to determine *when* to invest in stocks and when to hold cash equivalents. By timing the market, managers add additional risk to the portfolio, as it becomes more likely the investment results of the fund will differ from that of the overall market.

MPT tells us that passive investing, including being fully invested *at all times* (not attempting to time the market), is beneficial and that the additional expense of paying higher fees to the managers of actively traded mutual funds is not justified. Of course, this conclusion of MPT is not universally accepted. Those who believe in technical analysis are the most adamant in their refusal to accept these premises. After all, if it were impossible to predict future prices by studying a stock's price history, then technical analysis would be a bogus science. This controversy is not likely to go away quietly. We'll take a look at some of the evidence and you can decide whether passive investing is suitable for you.

Do You Make Investment Decisions Alone?

Being in an investment club is fun. It's a great learning experience for people who are beginning their investment education. Members usually meet once per month, discuss various possible investments, and learn how to conduct research to analyze the investment worthiness of a company. The question remains: Do the portfolios compiled by these investment clubs outperform the market? Surveys of investment clubs tell us that these clubs are generally successful. But such surveys are flawed. In a study covering a six-year trading history of 166 randomly selected investment clubs (clients of one unnamed large discount brokerage firm), professors Brad Barber and Terrance Odean concluded that investment clubs "educate their members about financial markets, foster friendships and social ties, and entertain. Unfortunately, their investments do not beat the market."[15]

Many individual investors make their investment decisions on their own, without the comfort of being able to discuss those selections with other investment club members. Some seek advice from professionals, some rely on tips, and some even (I shudder at the thought) seek advice from Internet chat rooms. Do individual investors, regardless of whether they seek anyone else's advice, outperform the market on a consistent basis?

THE VERDICT, PART I. SHOULD YOU CHOOSE YOUR OWN STOCKS?

The evidence says no. Barber and Odean studied more than 2 million customer trades over a six-year period and found that individual investors significantly underperform the market.[16] They also found those who make the highest number of trades, running up the highest expenses, perform worse than those who trade less. This is an example of actively managed accounts performing worse than less actively managed accounts.

It may not be surprising that public investors who trade actively underperform their peers who trade less often, but can the situation possibly be the same for accounts managed by professional mutual fund managers? See the Verdict, Part II in Chapter 5.

ACCEPTING THE CONCEPT OF PASSIVE INVESTING

If you, as an individual investor, cannot expect to beat the market on your own, what can you do? Must you accept below-average returns? Must you pay someone a fee in an attempt to earn better returns? Fortunately, there's an acceptable alternative. If you are willing to give up the dream of making an overnight killing in the market and to accept the fact that beating the market on a regular basis is an unlikely occurrence, then you can make the decision to accept returns that match the overall performance of the market. If you do that, you gain:

- Bottom line: You make more money. Average returns are better than below-average returns.
- Your trading costs are reduced, allowing you to make more money than those who invest in traditional mutual funds.
  - Passive investing involves fewer trades, lower commissions, and lower management fees.
  - By not selecting your own stocks, you trade less often, reducing costs.
  - You no longer have to spend time researching stocks to buy. No more analyzing balance sheets to determine financial soundness. No more studying historical stock price charts. No more depending on others for investment tips.
- The volatility of the value of your portfolio is reduced.
- Your tax situation improves, as passive funds seldom pay capital gains distributions.
- You suffer less stress, as you know in advance that the value of your portfolio increases or decreases in line with the market averages.

As mentioned earlier, owning index funds is becoming more and more popular, and the number of investors who choose to own shares of index funds is increasing. Even the current adaptation of the prudent man rule encourages this investment choice.

The managers of actively traded mutual funds are not going to disappear, and they are not going to stop trying to convince you to give them your money to manage. That's a good thing, both for you as an indexer and for the market. In order for investing in index funds (indexing) to work well, there must be those who do *not* adopt this strategy. If everyone owned only index funds, there would be virtually no trading. If neither investors nor professional money managers were attempting to beat the market, no one would be buying or selling stocks. Everyone would own the same or similar portfolios. Don't be concerned: Human nature being what it is guarantees that this will never happen. Be satisfied that if you choose indexing, you are making an investment choice that puts you ahead of the game. If indexing does not sound like something that appeals to you, be patient. In Part IV we'll use options to improve the performance of passive investing—an improvement that increases profitability and reduces risk.

Summary

The normal distribution of events, as represented by a bell curve, tells us that some investors and professional money managers will beat the market. But some also will fail in their attempt to beat the market. Since it's impossible to predict, in advance, just who the winners and losers will be, it's wise not to attempt to do so. It takes time, money, and energy to conduct the research necessary to try to beat the market yourself. It's foolish to hire others, incurring management fees on top of research and trading expenses, in an attempt to do so. Accepting an average return is a much more efficient method of investing. By saving the costs of those management and trade execution fees, investors are likely to be ahead of the game. Thus, indexing is not only expected to match the market, but, by saving all those extra costs, it is expected to do better than the professionals and beat them.

Frank Armstrong, an SEC registered investment advisor, put it this way: "Notice that we are not saying that you can never win, only that it is unlikely you can consistently win enough to overcome the costs of trying."[17]

CHOOSE INDEXING

MPT teaches that owning an assortment of index funds is the most efficient method for public investors to achieve a satisfactory return on an investment. Buying a mix of index funds may be rewarding, but it's not an exciting strategy. If you are the type of investor who wants to own a volatile portfolio with lots of "action," then indexing may not be suitable for your personality. But most people would be happy just to outperform the market year after year and would consider such an achievement as anything but dull. The strategy taught in this book enables you to actively participate in managing your portfolio by combining indexing with a hands-on options strategy. Investors who want only a small amount of hands-on decision-making can modify the strategy.

BEYOND INDEXING

The investment methodology outlined in this book goes way beyond traditional indexing. You are going to learn to go two steps further when building a suitable investment portfolio. Part II presents a discussion of the exchange traded fund (ETF), an improved version of the traditional mutual fund, and explains how to make them your major investment vehicle. Some ETFs are essentially index funds, and those are the ones to which we will pay the most attention. ETFs have many advantages over traditional mutual funds that make them a wiser choice for most investors.

In Part III, you'll learn about stock options and how to use them to enhance investment returns and reduce the risk of owning a diversified stock market portfolio. Part IV merges the strategies into one comprehensive, easy-to-adopt method of investing. You'll learn how to combine the strategy of covered call writing with the ownership of ETFs.

After you follow the recommended investment strategy, your portfolio will meet the requirements of MPT: reduced risk with the potential for better returns. Such an investment portfolio provides you with many of the benefits of investing in a hedge fund, but without having to pay the high fees.

But first, let's take a brief look at hedge funds.

CHAPTER 3

Hedge Funds

A hedge fund operates like a traditional mutual fund. The management team pools money raised from investors and puts that money to work in a wide variety of investment vehicles. But hedge fund managers are allowed a great deal of flexibility in choosing their investments and can use investment tools and techniques not available to managers of traditional funds. Their goal is to hedge, or reduce the risk of owning, their investments. For example, hedge funds are allowed to play both directions of the market by being long certain securities and short others simultaneously. Hedge funds use derivative products, such as options and futures, and have the ability to borrow money in an attempt to generate additional profits by using leverage. (Leverage means using borrowed money [buying on margin] to enhance returns without increasing the size of an investment.) Hedge funds also can participate in arbitrage opportunities. Arbitrage involves the simultaneous purchase of a security in one market and the sale of the same security, or a derivative product (an instrument whose value is dependent on the value of the first security), in another market. Due to occasional short-lived market inefficiencies, the arbitrageur occasionally can profit from price differentials between the two markets.

Traditional mutual funds have much stricter requirements and are not allowed to sell stocks short. Nor are they allowed to use leverage or derivatives. A few mutual funds can write covered call options (discussed in great detail in Part III), but most are prohibited from using any options strategy. By being forced to invest only on the long side of the market, traditional funds do well in rising markets and fare poorly when the stock market declines. The best they can do in declining markets is to hold cash instead of being fully invested. One of the great advantages of owning shares in a hedge fund is the opportunity to profit during both bull and bear markets.

Although hedging techniques cannot guarantee profits, they do reduce portfolio volatility and make it significantly more likely that investors earn a profit over the long term. That is why investors usually benefit when they add a hedge fund to a traditional investment portfolio. But most public investors don't understand the advantages of reducing the volatility in the value of their portfolios; instead they are concerned only with how much money they can make *right now*.

A great many public investors (and professional money managers) suffered huge losses during the recent bear market, making many afraid to invest and encouraging them to find investments that make money in both rising and falling markets. Hedge funds represent an investment choice to fill that niche.

FINDING A GOOD HEDGE FUND

Finding hedge fund managers who are skilled traders and who understand risk management is not an easy matter. Using leverage provides an opportunity to increase profits, but it also can result in increased losses if investment risks are not managed carefully. As with traditional funds, not all hedge fund managers are competent to manage an investor's money. But it's difficult for public investors to obtain the information necessary to judge the qualifications of hedge fund managers.

Unlike traditional mutual funds, hedge funds cannot advertise themselves to public investors. Legitimate funds managed by qualified management teams can advertise only to "qualified" investors, typically those who have $1 million or more to invest. Thus, public investors must learn about specific hedge funds from sources of unknown reliability.

INVESTING IN HEDGE FUNDS: THE BAD NEWS

Hedge funds charge very high fees to manage your money. It is customary to charge an annual management fee of 1 to 2 percent of the value of the investment, but that's not much more than traditional mutual funds charge. The real incentive for hedge fund managers is profit sharing—managers keep 20 percent of all profits. Because hedge funds originally were marketed only to very wealthy clients, and because these clients are willing to pay big fees for excellent results, the tradition of paying 20 percent of the profits continues. Investors get to keep 80 percent of the profits (before the 1 or 2 percent management fee) and incur 100 percent of all losses. Thus, making money is difficult for investors. Despite those high fees, many public investors are eager to enter the world of hedge funds.

Consider these facts: Operating a hedge fund can be very lucrative; many public investors are searching for hedge funds; hedge funds are unregulated and investment results do not have to be audited. These conditions made it very attractive for scam artists to enter the business of operating hedge funds. On top of this, the success of existing (legitimate) hedge funds during the bear market attracted investors who were losing large sums in traditional funds. Their ability to make money during bear markets enabled hedge funds to greatly outperform traditional mutual funds. News of their profitability spread, grabbing the attention of investors everywhere.

But hedge funds were not originally designed for the masses. Instead, an investor had to be "qualified" before being allowed to buy shares of hedge funds. These requirements barred the vast majority of public investors.

The rationale behind those restrictions is that hedge funds are considered too risky for most public investors. They are unregulated, given great latitude in the nature of their investments, and don't have to report their results—and if they do report results, often they are unaudited. Note that public investors were allowed to invest in the stock market and lose huge sums when the markets declined rapidly. Even the prudent man rule suggests that owning stocks is a conservative and intelligent thing to do. But investors were prohibited from buying shares of hedge funds because the government agency making the decisions thought these funds were too risky for the public. Imagine: Funds designed to reduce risk are considered too risky for the average investor!

Hedge Funds for the Masses

As stated, running a successful hedge fund is a very profitable proposition. Many new hedge funds were organized with the purpose of encouraging the public investor to enter the game. During the past three years, assets under management by hedge funds increased from $500 billion to $800 billion.[1] To make it easy to attract investors, initial investment requirements were as little as $5,000.

Deciding which hedge fund to invest in is even more difficult than choosing a traditional mutual fund. It's still impossible to know, in advance, who the skillful fund managers are and which funds are going to be successful. But beyond that, there often are no verifiable track records for the investor to consider. That makes choosing a hedge fund difficult. As if that's not enough, public investors have no idea of the background of the fund's managers.

In a recent article that is extremely critical of hedge funds, Neil Weinberg and Bernard Condon describe how many unqualified individuals were able to pass themselves off as qualified fund managers, open hedge funds, and raise capital from eager investors.[2] Although not able to advertise directly to investors, some were able to circumvent that rule by claiming huge profits. In turn, the tales of big profits sometimes were enough to gain a television interview for the hedge fund managers, during which they boasted of a great track record and told viewers how to obtain information on the fund. Notice that the managers were not advertising; they were merely describing their results to an interviewer.

Look at it from the perspective of hedge fund manager wannabes. If they can raise $50 million from the public, and if they earn a return of only 5 percent on the money, that's a profit of $2.5 million. Their 20 percent share of the profits comes to $500,000. That's enough money to attract many scam artists.

Unethical fund managers who are able to raise a great deal of money are in position to gamble with that money. If they take big risks in an attempt to earn large profits, they have nothing to lose. (They lacked integrity to begin.) If they go broke, it's not their money; if they hit it big and double the money, their share of the profits from a $50 million account is $10 million. These windfall possibilities, coupled with the fact that hedge funds are unregulated, was bound to attract some unscrupulous scam artists. Weinberg and Condon claim "it's amateur hour in the hedge fund business" because hedge funds are being operated not only by those well qualified to run such funds, but also by "shills, shysters, charlatans, and neophytes too crooked or too stupid to make any money." Sadly for public investors, the invested capital often disappeared quickly—either through trading losses or outright theft.

There are many excellent hedge funds available to the investor, but due diligence is required to find a legitimate fund with qualified managers. Good information often is difficult to obtain because legitimate funds are not allowed to advertise to those seeking information. Few take the time to attempt to verify the claims before investing after hearing (untruthful or exaggerated) claims of the fantastic results achieved by some hedge funds.

Fund of Funds

A breed of mutual fund is called a fund of funds. The managers of these funds invest money by buying shares of other funds—both traditional and hedge funds. Although this sounds like a good way to own a very well-diversified portfolio, consider the management fees. The investor who buys shares of a fund of funds must pay a management fee to those people who operate the fund of funds. Then the money is invested in other funds whose managers also charge a management fee. Finally, the hedge fund managers collect 20 percent of all profits. Too many fees!

If you ever consider buying shares of a hedge fund, be certain to read the prospectus carefully to determine the type of investments used by the management team and the level of risk involved. Remember, the greater the reward promised by the fund managers, the greater the risk required to earn that high reward. If possible, invest only in funds that produce an audit of their investment results.

DO IT YOURSELF

You can avoid the risk of hiring fund managers who are unqualified. You can eliminate the uncomfortable feeling of having money invested when you don't fully understand the investment methods used by those managing your money. If you follow the strategies outlined in this book, you won't have to worry about the integrity of the fund manager, because you will be managing your investments by yourself. There will be no worry about the managers taking more risk than you are willing to take, for you will be managing that risk yourself. In fact, if you adopt the methods described, your portfolio will be significantly less risky than the portfolio of a typical American investor—someone who buys a collection of stocks and seldom sells any of them (a buy-and-hold investor). Hedging is a way to reduce the risk of owning other investments, and the investment strategy described in this book reduces the risk of owning stock market investments.

If you learn to operate your own hedge fund, you are assured the fund manager is ethical. In addition, there are no fees to pay, and you keep all profits for yourself (except for taxes, of course). This book doesn't explain all of the many possible methods of hedging investments. Instead, we concentrate on two hedging methods that are easy for average investors to understand and implement. When you become satisfied with the results and feel comfortable, you can always expand your hedging education.

OR DO IT WITH HELP

If you like the ideas taught in this book and want to run your own hedge fund, but would like the reassurance of working with others, form an investment club. If you show this book to friends, family, and business associates, and if you suggest joining forces and adopting the strategies outlined here, you will be in position to discuss specific investment ideas with each other and rely on the pooled judgment of several people. That should help get you started, if you don't want to tackle this do-it-yourself strategy alone.

By pooling ideas and money, each club member contributes to the success of the club. These investment clubs represent a great educational opportunity. The NAIC (National Association of Investment Clubs) can help you get started with forming a club,[3] but be warned: The association is still using yesterday's investment methodology—namely buy and hold. The hedging strategy outlined in this book works well and is a sound basis for organizing a modern investment club.

A better choice for learning about investment clubs is bivio.[4] They offer an application enabling groups of investors to create and manage a club. Bivio is the only accounting service for investment clubs that supports options, and their software handles the club's bookkeeping chores.

In Part II we'll continue our journey with a discussion of exchange traded funds.