CHAPTER 1

Where Are the Customers' Yachts?

A TYPICAL INVESTOR'S EXPERIENCE WITH WALL STREET

I borrowed the title of this chapter from a book written by Fred Schwed Jr., a professional trader who lost a bundle of (mostly his own) money in the Crash of 1929. He described his experiences on Wall Street from an insider's point of view in a remarkably humorous fashion.

More than half a century ago, Fred Schwed Jr., who had survived the greatest of all financial market booms and busts, told the story of a tour bus of Nebraska farmers taken to downtown New York. The guide pointed out the major landmarks, including the Stock Exchange, and waved at the docks in the East River. "There," he said, "you see the yachts of the great Wall Street brokers." One of the farmers' children posed an important question: "But where," he asked, "are the customers' yachts?"

Although the book was originally published in 1940, it is as relevant today as it was then. The Internet with broadband access and real-time quotes has replaced the ticker-tape machine, and the laptop computer has replaced the pencil and the ledger book. However, the essence of Wall Street remains the same.

There is an old joke among investment bankers that states, "If you want a friend on Wall Street, buy a dog." I don't think it is quite *that* bad. In the investment business, just like in any business, there are bad *and* good people. However, in the investment arena, seeing people clearly is *essential* to your financial survival.

Because of the demands of work and family and limits on our time, we sometimes depend too heavily on Wall Street professionals to help with our investment nest egg. Whether you work through a broker or advisor or have chosen to do it yourself, you should always be in control and understand what is happening.

If you were buying a home, you would probably use a real estate agent—but you would not buy the home unless it met your needs and desires at the right price. The same is true with your investment portfolio. After all, it is your money!

The Adventures of Joe Investor: A Cautionary Tale

In order to gain an understanding of how Wall Street operates and the dangers of giving up your investor responsibilities, let us look at the fictional journey of a man we shall call Joe Investor. He represents a composite of different investors that I have observed over time. As the TV crime shows say, the events are true but the names have been changed to protect the innocent.

The cast of this little drama includes five major characters, each loosely based on reality:

Joe Investor: the protagonist of the story. Joe is a likable fellow who wants to be among the investing elite.

Emily Advisor: Joe's accountant and financial advisor for many years. She is reliable, conservative, and honest.

Harry Bigbucks: Joe's golf partner. He is an egotistical investor who enjoys bragging about his financial gains.

Wally Broker: a "man with a plan" who graciously allows those in his inner circle to call him *Mr. Broker.* His firm, Wheeler, Dealer, & Company, is where the elite meet to make lots of money.

A. Hedgefund Guru: the keeper of the investment secrets. Silent, powerful, mysterious. This man has made lots of money but no one really knows how.

The Background

Joe Investor had been extremely successful in his chosen profession and was known for his ability and insight. He fancied himself a keen observer of human nature and aimed to be a high achiever in all his endeavors. Joe decided to approach his investments in the same way, aiming for top-notch performance.

He had used his accountant and financial advisor, Emily Advisor, for most of his financial planning. Ms. Advisor's advice was boring because she tended to stick with low-cost mutual funds. However, the arrangement was convenient because Ms. Advisor was quite familiar with Joe's financial situation and was able to do a significant amount of financial planning for relatively low cost.

The Introduction

Our story begins one sunny day, as Joe was playing a round of golf with his buddy, Harry Bigbucks. As they stood together on the green, the topic of investing arose.

Mr. Bigbucks announced that he used the investment firm of Wheeler, Dealer, & Company exclusively. When Joe inquired further, Harry described how all the true players were also clients of the firm and how a new account representative had been making an absolute fortune for him the last several months in technology stocks. Joe listened and then filed the information away, making a mental note to mention this to his accountant, Ms. Advisor, at their next meeting.

As the year progressed, Harry Bigbucks and the other members of their little golf group seemed to be making a killing. It was all Joe heard about at every social event he attended! As he looked at his account statement each month, which was also rising in value but not at the same blistering pace, he began to feel that he was missing a major money-making opportunity.

Joe talked to Harry about his concerns, and he graciously arranged a meeting with his account representative at Wheeler, Dealer, & Company. At the meeting, Joe was introduced to Mr. Wally Broker (known as Mr. Broker to both his friends and clients).

Mr. Broker was everything that Joe imagined a successful investment representative would be, from his crisp, custom-made suit to his corner office with a mahogany desk and an incredible view of the harbor. The photos on his wall showed him with prominent industrialists, sports figures, and even a former president. Mr. Broker discussed his relationships with all these people in detail and then handed paperwork to Joe to establish an account to get started.

As he reviewed the paperwork, he noticed that Mr. Broker's fees were significantly larger than Ms. Advisor's. He asked if this also included the financial planning that Ms. Advisor did. Mr. Broker responded—with a tinge of annoyance in his voice—that his sole focus was as an investment specialist, not a financial planner.

Joe knew that Ms. Advisor would not cut the fees for the planning services; therefore, Mr. Broker's fees would be an *additional* cost. However, Joe decided to go ahead, thinking it *always* costs money to play with the big guys.

Over the next several months, it looked like the right decision. Mr. Broker had placed him in some technology mutual funds. These funds had higher fees and expenses than Ms. Advisor's boring funds but were outperforming them by huge amount. As Joe attended local social events, he became even more comfortable as he heard about the profits his other friends were making in these funds.

The Big Opportunity

Later on that year, Mr. Broker called Joe and asked him to come down to Wheeler, Dealer, & Company as quickly as possible to discuss an incredible investment opportunity. When he arrived, Joe also saw Harry Bigbucks in the office. At that moment, Joe truly felt like the major player he had always wanted to be.

Mr. Broker announced that the premier hedge fund that he used for many of his clients was now accepting new money. Joe wasn't quite sure what a hedge fund was but noticed that it took 20 percent of the profits in addition to the normal management fees. He also learned that the minimum investment was quite high.

With that amount of money involved, Joe wanted to speak to the man in charge of the hedge fund. Mr. Broker grumbled that this would be difficult to arrange but that he would try.

The following day, the three of them visited the office of the hedge fund's managing partner, A. Hedgefund Guru, known only as "the Guru" to everyone, including his children. As they crossed the trading floor on the way to meet this man, Joe was impressed by his operation, with an array of televisions tuned into news programs around the world.

Mr. Broker announced that he would ask the questions since the Guru was very busy. In response to a question on the state of the market, the Guru simply pointed his right index finger up. Then, when they asked about technology stocks in particular, the Guru pointed his right index finger even higher.

At that point, the Guru took a phone call, listened for two minutes, and proceeded to smash the handset on his desk. Mr. Broker said that this indicated the meeting was over. Joe was not quite sure what had happened but noticed pictures of the Guru with three former presidents, the current president, royalty from five major countries, and the actress who won the Academy Award last year. The Guru was *definitely* a major player.

Joe talked to his long-time accountant, Ms. Advisor, who adamantly advised against participating. Ms. Advisor informed him that this was a risky proposition since no one had a clue what this hedge fund even *did*.

Her words fell on deaf ears. Mr. Bigbucks had already committed to the deal, and Joe could not bear the thought of hearing "I told you so" over their next round of golf if this thing was successful. Joe decided to ignore his accountant's advice.

The Wind Shifts

For the first few months, the hedge fund investment was *incredibly* profitable. It ended the year with stellar returns, even after the fees. (Mr. Bigbucks had bought a Porsche, separated from Mrs. Bigbucks, and began showing up around town with a much younger girlfriend named Rome Hipstone. Rome was the young, blond wild child of the founder of the Hipstone hotel group.) Six months after Joe's initial investment, quite unexpectedly, the returns of the hedge fund turned negative one month. Joe wasn't too concerned; he figured that nothing went straight up. However, he *did* start to worry after there were two more consecutive down months.

Mr. Broker informed him that the firm used some leverage, which had led to some short-term volatility, but that this was a buying opportunity. Mr. Bigbucks decided to double his initial investment, but Joe had a funny feeling and decided not to increase his. The next month, the hedge fund rebounded, and Joe began to wonder if he had made the right decision.

Then, one day shortly after this dramatic rebound, Joe read in the local newspaper that the hedge fund was closing down.

Apparently, the Guru had made a bad bet in the currency market, suffered a nervous breakdown, and had not left his bed in the last week. Joe called Mr. Broker at Wheeler, Dealer, & Company and learned that the losses in the hedge fund were quite substantial and that he would only get back

60 percent of his original investment. Sadly, Joe had learned the first lesson of investing, one of 22 valuable lessons I will be presenting in the coming chapters. A summary of these lessons is provided in Chapter 14.

Investment Lesson #1: Profitable investing is not like a contagious disease that you catch from being around the right people.

Joe visited Wheeler, Dealer, & Company to see what could be done to salvage the situation. Mr. Broker tersely informed him that there was very little to be done. Joe mentioned that he really did not understand much about the risks involved with the hedge fund. Mr. Broker sympathized but mentioned that all this was clearly discussed in the subscription document that Joe had signed. He had even initialed the sections involved.

Joe also realized that he had incurred substantial investment fees in this money-losing investment, and he suggested that Wheeler, Dealer, & Company refund some of them. Mr. Broker again sympathized but stated that the firm's policy allowed no refunds and mentioned that these losses were still less than those of Mr. Bigbucks. This fact did not greatly improve the situation. (By the way, Mr. Bigbucks had reconciled with his wife after he was forced to sell the Porsche to cover his losses and Rome left him.)

Mr. Broker offered to make it up on the next deal, but this was a small consolation. He then offered to have Joe and his wife as guests on the yacht that he had purchased with the year's bonus. Mr. Broker asked Joe not to mention this to Mr. Bigbucks, as there was no way he could invite the Bigbucks, since Mr. Broker and Rome Hipstone were now a couple. Joe had learned the second lesson of investing:

Investment Lesson #2: What makes Wall Street rich does not necessarily make the customers wealthy.

Figuring Out Where Joe Went Wrong

Joe quickly realized that he had no alternative but to accept the situation, but he remained in a deep depression for several weeks. He finally decided to speak to his old friend and ally, Ms. Advisor, to determine just how he got into this situation and how to avoid doing it again.

Ms. Advisor truly felt sorry for Joe since the two had a close and profitable relationship for many years. She mentioned that Joe did not have a clue as to what either she or Mr. Broker was doing with his investment funds. It was as if Joe really just did not care to take part in the important decisions being made on his behalf. When Joe mentioned that he went with his gut instincts about people, Ms. Advisor countered that Joe did not run the rest of his life or business this way. Although Joe might choose to delegate responsibility, he always clearly understood what was involved in all of his businesses. However, in investing, Joe seemed to rely on luck and instinct instead of his own intelligence. It was then that Joe learned the third lesson of investing:

Investment Lesson #3: When it comes to investing, it is better to be smart than lucky! If you are smart, you make your own luck.

The two then tried to analyze why Joe had been attracted to Mr. Broker and the Guru in the first place. Joe mentioned that their initial returns had been incredible. His friend and golfing buddy, Mr. Bigbucks, as well as all the other members of his golf group, had done extremely well during last year, and Joe felt as if he were missing an incredible opportunity. Ms. Advisor asked if Joe had looked at the long-term performance and some of the long-term risks involved. Looking embarrassed, Joe admitted that he had not done any of this. He had been seduced by the opportunity for easy overnight riches.

Ms. Advisor discussed the financial planning that she had done for Joe's business and personal portfolio. When the two first started working together, they spent a great deal of time analyzing Joe's long-term goals for retirement and for his family. They had carefully analyzed the trade-off between the time needed to achieve financial success and the time he wanted to spend with his family. Joe had indicated that, to him, incredible wealth was not worth it if he could not have a life. They had formulated a long-term investment program that was working according to plan, until this disaster occurred.

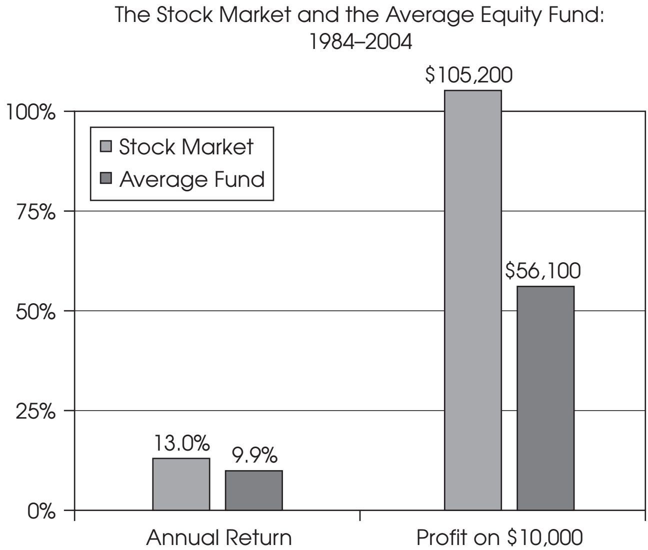
Ms. Advisor said that the *long-term performance* of his portfolio is what matters. Investment performance can vary in the short term even if it is successful in the long term. By contrast, Joe's hedge fund investment was the exact opposite. It had been quite profitable during a short time period but was a significant loser in the long term. This realization was to teach Joe the fourth lesson of investing.

Investment Lesson #4: Think long term about both *return* and *risk* when analyzing your investment.

The two then discussed Ms. Advisor's preference for low-cost funds, especially index funds. Joe did not understand why Ms. Advisor preferred these boring investments when so many better opportunities seemed to be out there. Why was Ms. Advisor so skeptical about investment options that could produce higher returns? The information that Ms. Advisor revealed in response to this question was truly shocking.

The sad truth is that most mutual funds do not even beat the market (as represented by the S&P 500) over a long-term period, according to the Bogle Financial Markets Research Center (see the figure on next page).

Joe was in disbelief. This seemed to be directly the opposite of all the conventional wisdom that he had read and heard all his life. He asked about all those advertisements that he had read, showing funds outperforming the S&P 500.



Source: Bogle Financial Markets Research Center, *In Investing, You Get What You Pay For*. Remarks by John C. Bogle, The World Money Show, Orlando, Florida, February 2, 2005. www.vanguard.com

Most Mutual Funds Don't Beat the Market and Can be Hazardous to Your Wealth

Jack Bogle, founder and former chairman of the Vanguard Group, one of the largest mutual fund groups in the United States, argues that most mutual funds do not beat the S&P 500 over an extended period of time. He argues that the stockpicking abilities of most mutual funds do not generate excess returns; instead, they actually cost the average investor money.

Mr. Bogle cites Jack Meyer, former head of the Endowment Fund for Harvard University, who said:

> Most people think they can find managers who can outperform, but most people are wrong. I will say 85 percent to 90 percent of money managers fail to match their benchmark. Because managers have fees and incur transaction costs, you know that in the aggregate, they are deleting value. The investment business is a giant scam.

Mr. Bogle also said in a recent speech:

> During the period 1984–2004, the average fund lagged the market by 3.1 percentage points per year. While the U.S. stock market, as measured by the Standard & Poor's 500 stock index, provided an annual rate of return of 13.0 percent, the return on the average equity mutual fund was 9.9 percent.

Ms. Advisor replied that many of these advertisements showed the performance over shorter time periods such as 1 or 3 years, rather than longer time periods such as 10 years. Joe said that this sounded quite like the disastrous hedge fund investment that he had just made. Ms. Advisor nodded her head in silent agreement.

Joe asked about the mutual funds that were the true *outperformers* over the long term. Ms. Advisor admitted that there *were* funds like this out there, but there were some additional issues to consider before investing in them:

- Funds like these were quite successful with substantial amounts of money and often were closed to new investors. Joe would not have the opportunity to invest if they are closed to new investors.
- Often, these funds achieved their remarkable track records when they only had a small amount of money under management. They were able to find hidden opportunities that were so small that these were overlooked by the larger investors. Successful track records attract investors' money, and these funds may now be substantially larger than they were previously. With this additional money, they may not be able to achieve the spectacular performance numbers that they achieved before.
- Some of these funds were highly concentrated in a few stocks with minimal diversification. This was fine, as long as the stocks were performing. However, if the

investment manager made a mistake, it could have a disastrous effect on the portfolio.

- The management and other fees for these funds were usually higher than those of the low-cost index funds that Ms. Advisor favored. These fees were usually charged whether or not the funds made money for the investor. Upon hearing this, Joe shuddered in pain, as he recalled the recent conversation on fees with Mr. Broker.

Ms. Advisor agreed that these investment opportunities existed but demonstrated that they were extremely difficult to find. She found it much easier and simpler to focus on consistent, low-cost index funds. With that admission, Joe was to learn the fifth lesson of his investment career.

Investment Lesson #5: Outperforming the benchmark averages, such as the S&P 500, over the long term is much more difficult and rare than is commonly thought.

Realizations and Resolutions

After this conversation, Joe realized how little attention he had been paying to his investment portfolio and how minimal the interest he had shown in its management. This was unusual, since he did not run the rest of his life this way, and the success of his investment portfolio was the key to achieving the lifestyle he had always envisioned. Joe was very fortunate that this last mistake had *delayed* his retirement plans but had not destroyed them.

Joe also realized that he relied too much on other people's expertise. Although Ms. Advisor had been a good choice as a financial advisor, the selection of Mr. Broker had been based on greed and envy.

This was not the only mistake he had made. Joe had not understood what either of these people was doing, and thus had lost control of the situation. Perhaps, if he had discussed this with Ms. Advisor earlier, he might have avoided his hedge fund disaster. He resolved never to let this situation occur again and to have a clear strategy for his investments.

After making this resolution, Joe once again felt in control of his destiny. He began to feel that he could make effective decisions if he used Ms. Advisor or if he did it on his own. He was not going to rely on his emotions or let them run him. Joe realized that taking charge of his investments does not mean taking on another full-time job. He also educated Mrs. Investor, his daughter Princess Investor, and Joe Junior, his son. It was essential that they *all* have the investment tools to prosper in the real world.

Summary

Joe learned many lessons the hard way. His experiences with Mr. Broker and the Guru taught him well. I hope it will teach you, too. Here are the lessons to remember:

Investment Lesson #1: Profitable investing is not like a contagious disease that you catch from being around the right people.

Investment Lesson #2: What makes Wall Street rich does not necessarily make the customers wealthy.

Investment Lesson #3: When it comes to investing, it is better to be smart than lucky! If you are smart, you make your own luck.

Investment Lesson #4: Think long term regarding both *return* and *risk* when analyzing your investments.

Investment Lesson #5: Outperforming the benchmark averages, such as the S&P 500, over the long term is much more difficult and rare than is commonly thought.

The underlying teaching is simple: *Be your own best friend and ally* by learning all you can about investing your hard-earned money. Depending on others is prudent only if they have earned your trust and respect.

For additional information and supplemental resources, visit www.FollowtheFedtheBook.com.