PART I

OLD SCHOOL . . . OF THOUGHT

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CHAPTER 1

Buy and Hope: The Scam?

Over the years there has always been a debate over whether investors should buy and hold stocks and never sell them versus the active pursuit of trading stocks to earn profits. I have no idea why anyone would take the risk that a corporation will last longer than you will or for that matter what buy and hold means. Why would anyone purchase a stock, and then never sell it? One common reason is that if the stock pays a dividend—the earnings of a corporation paid out to its shareholders—you can get cash flow just for holding the shares. Some people just want to accumulate wealth and hold onto stocks forever, but even the desire for endless fortune doesn't mean an endless holding period. Would you still want to own shares of a typewriter company?

Of course the basic assumption of buying and holding a stock is a better bet than the old adage of buy low sell high. The concept we are exploring here is buy and never sell. Who would want to sell a company that is supposed to make profits over the long haul? Plus, how would you know when to sell? If you hold a stock forever, it shouldn't matter when you buy it since it will be a one-time transaction. This would be fine if most corporations made money in large amounts forever and paid out the profits to you. If you suffered the horror of a basic finance class in college, the value of a company was determined by looking at the long-term earnings or cash flow of a firm if you wanted to answer the test questions correctly. That would be fine if the world had no shares traded on public exchanges where the price to buy and sell is determined each day

by supply and demand, not rational analysis of a firm's true value. Plus, I have no idea how people in a public market would ever come to a consensus to figure out the value of a big company like General Electric (GE). Even the executives at GE can't tell you the real value of the company. This is because there is no real value, only the price a buyer and seller can agree on at that moment in time in which the stock trades hands.

Holding a stock has to have some purpose to the buyer. Is the collection of dividends over time the motivating factor? What if the company stops paying dividends, do you continue to hold the stock? We could spend a lot of time discussing the matter, but buy and hold is simply an observation of what one does, not a strategy. If you owned stock in Philip Morris and held it for 50 years, people would have told you your stock was doomed to fail in light of the company's continuous legal litigation. In fact, it was one of the best performing stocks of the last 50 years, but you would have had to hold it a long time against the best advice of experts. On the other hand, you could have gone with the crowd and purchased stock in a good old-fashioned company that made a product that wasn't going to go away. You could have bought stock in General Motors, only to have your investment go belly up in the recent financial crisis. Nobody back in the 1950s could predict what would be around today, nor should we try to make guesses about how the world will be in 50 years. Let's leave that to shows like NOVA or to Hollywood. It's more fun and cool to watch years later when we see how far off we were. The question is not whether to buy and hold. By getting you to ask if you should buy and hold, Wall Street has tricked you into thinking about it as if it is a strategy. No reasonable person would bet that anything is a sure thing for 50 years, so we need to start off with the first insight on Wall Street: Buy and hold is dead. But the truth is, it never really existed.

I think the first person to say this was a stockbroker. Wall Street manufactures publicly traded securities for people to consume. Some work, most don't. Do you want someone to buy a product from your store only to have it returned? No. So why would you think Wall Street would ever want their goods returned? Sure, money is made when people buy and sell shares, but they never end up back on the same shelf they came from.

We will all die sometime, and the desire to make money during our lifetime is just human nature. Why not accept this fact and

move on? Wall Street knows this is how people feel, and they provide the public with limitless ways to engage the markets. The problem is that each idea is presented as if there is only one solution to choose. Think about it; everyone is looking to make easy money. If you had "the answer," why would you need to look anywhere else? That is what this buy-and-hold thing is all about. You make a smart decision one day and never look back. Many people, especially after the dot-com crash, and definitely after the 2008 financial crisis, found out that buy and hold was not a successful strategy. And there are other similar scams that resemble this perennial idea. I use the term scam not in the sense that something doesn't work, but that it is presented as the eternal system. You can't beat the system unless you know the game.

Blame the Dutch!

Forget blaming the French for socialism or Wall Street fat cats for financial meltdowns. It was the Dutch that got us into this mess more than 400 years ago. While trade and commerce is an ancient practice, the first stock didn't spontaneously generate until 1602, when the Dutch East India Company was founded. Why was this important, outside of being the first stock? First of all, this was the first *joint-stock* company, meaning regular people like middle class merchants were able to invest in a public company. On September 1 the public subscription period was over. Five hundred thirty-eight subscribers, including craftsmen and small entrepreneurs, were given shares that were freely transferable.[1] Before this there was a barrier to entry for investments. The idea of selling a piece of a company in order to lower the risk to any one person was not new, but allowing anybody with the money to buy shares was ground breaking. The Amsterdam Stock Exchange was established the same year just so people could trade shares of this new corporation.

Why did it take so long for the madness to start? First off, you can't sell stock to those that have no money, freedom, or laws protecting ownership. The feudal system of a Lord owning the land and you working on it doesn't cut it. Starting around 1433 the Duke of Burgundy, having won the genetic lottery, decided to unite towns previously under no rule into a cohesive sovereign nation. Amsterdam was one of those towns that became quite wealthy as the shipping business with Asia boomed. Despite a war with Spain

that lasted 80 years and independence that wasn't official until 1648, the Dutch Republic managed to become one of the first free economies. It worked. While Portugal and Spain were used to the limelight of international trade, they lacked property rights and contractual obligations. Remember that the Dutch were a republic, and while there was not the same personal freedoms we think of today, not having to deal with monarchs who held ultimate power was good for business. It was this ability to make contracts with laws and enforce them that allowed corporations to open up to the general population of wealthy merchants. In the end it was the rule of law that gave rise to what we think of as economic freedom. It helped that the Dutch had one of the strongest navies in Europe at the time. When the Dutch East India Company started to take control of East Asian trading routes, it was met with strong opposition from Portugal and England.

While this is all very interesting, how did the stock do? Investors received an average 25 percent return on their money during the first 15 years.[2] Eventually creating monopolies, the company dominated trade with Asia and at one point paid out a 40 percent dividend to shareholders.[3] Does this sound like a stock you would like to own? With a return so rich and dividends paying you to stick with it, nobody would look this gift horse in the mouth. This was the first buy-and-hold stock—no hope needed. At the peak, the company even had 40 warships and 10,000 soldiers on the payroll to keep market share. At the time I guess people were not worried about socially conscious investing. Also, it wasn't just great management or a business idea that helped its track record. For the first 21 years the company had a monopoly from the government on colonialism. It took a few years for operations to become profitable enough to pay a dividend, starting in 1610. After priming the pump with a government monopoly and borrowed money it was not hard for a whopping 18 percent average annual dividend to be paid for most of the 200 years it was around.

So, what happened to the first great and powerful multinational corporation? After almost 200 years of making money for shareholders, inefficiencies and corruption sank the ship. The industry was changing and the ability of the firm to keep up was challenged. While many reasons are given, the one I find most fascinating was the dividend policy. Starting around 1730, the dividends paid by the company exceeded the *earnings*.

earnings An actual profit, the fundamental point of capitalism, and a key pressure point between shareholders and corporate management. When earnings exist, shareholders generally tend to nag companies to share the wealth. After all, shareholders by definition have a claim on earnings. However, just because earnings exist doesn't mean you will get your hands on them. In some cases, the desire for management to pay and shareholders to receive earnings are so strong, dividends are paid out without actual earnings to cover it. This is called denial. Generally denial ends in bankruptcy.

Only by borrowing money short term against future income was the company able to continue. (This sounds a lot like companies that go out of business today.) Nationalized in 1796 and officially shut down in 1800, the company left shareholders with nothing in the end. Sure, if you had put money down in 1602 and never sold there were no complaints, but by 1800 you would be on the sixth generation of stockholders. Your great- great- great- grandkid would not be happy. Obviously, despite the loss of value in the end the company was a huge success. You can see why investors would spend the next 400 years trying to find the next Dutch East India Company. All your family would need to do is establish a legacy of wealth.

The bottom line is the system worked out well. It was the beginning of convincing the uneducated public to put up money to capitalize a shaky operation and strip out the value using borrowed money until the entire organization fell apart. Paying a dividend kept investors holding onto shares, at least until the dividend became a liability that eroded the assets and blew up the company. Democratizing wealth for those that took the risk was here to stay.

All the Wrong Moves?

As we learned from the Dutch East India Company, a long-term track record of good investor returns doesn't ensure success over the long haul. So, if one of the most successful companies in history can go bust, what about the worst companies? What if a company was in a constant state of being sued, sold a product that killed people, and had a rich dividend payout that was anything but safe? Just to be clear, my father is a lung cancer survivor. He smoked for most of his life until the day he was diagnosed. At our firm, I recently

made the decision to not invest money in tobacco companies. This was easy to do and I don't have a strong opinion about it, but when there are thousands of companies to invest in, why worry about a client who may be offended by it? Also, I find that people who are okay buying tobacco companies can change their minds when a loved one is affected. Now that I have disclosed my biases, let's let the numbers speak.

People hate tobacco companies, and Philip Morris is the biggest around. While smoking may not be great for your health, a portfolio that had the advantage of a crystal ball would have profited from investing in Philip Morris. It was not always the big dog of death. Back in the 1960s the firm was the underdog until the Marlboro Man took pole position and led the company to cigarette heaven in 1983. Think about it: You are an investor looking at buying the sixth largest cigarette company back in 1960. Would you be thinking to yourself that this is a great long-term investment? What about buying the leader, or at least the top three? Twenty-three years later it would be number one, but only because it changed the way it operated along the way. You would have known none of this back then. Believing that management would pull through over decades of adversity would require ignorance or a leap of faith. How could you have known that the tobacco giants would be sued by states and a slew of people? But to make an investment that they would lose and rise again would be wishful thinking. It happened over and over again.

Investors don't like when the government sues their companies. Share prices tend to go down if you can't figure out the future liability of a lawsuit. When the aim of suing the company is to put it out of business, or effectively damage it permanently, shareholders tend to exit. So, with the tobacco companies being sued all the time, why would you want to take the risk? For starters, tobacco companies didn't lose cases until their luck ran out in the 1990s when individual states ganged up and filed the largest suit in the industry. It was called the Tobacco Master Settlement Agreement (MSA). In 1998, 46 states settled for a total of $206 billion over the course of the 25-year agreement. Of course, the irony is that the companies will have to stay in business in order for the states to collect. With balancing state budgets a problem these days, the profitability of tobacco firms is important to the very states that sued them. In fact, there is a vested interest in keeping tobacco companies alive so states can continue to get money out of them.

While this is not only socially horrible and expensive, the reality of the returns tells a different story. Between 1925 and 2003, the company earned an average compound return of 17 percent, while the S&P 500 returned 9.3 percent during the same period of time.[4] Every time it was sued, Philip Morris' stock price would hit the bricks only to rebound to higher levels. I remember the first time I played with the evil empire when I was a stockbroker still in my 20s. It was around the time of the 1998 settlement, and I watched the firm trade lower and lower. A broker friend of mine said his friend was an attorney and studied the case. The attorney was convinced the MSA would kill Philip Morris. There was only one observation I made: The stock was still trading and states needed the money. As the dot-com crash killed the economy, the share price of Philip Morris fell in kind. In the low 20s, the dividend was close to 9 percent. I wasn't a stock genius, but knew that investors would come in to buy the shares like they always did now that the dividend was rich and your other option was losing your shirt in tech stocks. The money flowed into the stock as *fundamentals*, a high yield, and the cynical investing public saw the opportunity and took it. It wasn't great for society, but neither were the colonial activities of the Dutch East India Company. Plus, a stock doesn't know you own it.

The effect was making money, and my clients were happy. A healthy dividend yield allowed those that wanted to take on the risk of further bad news to earn an above market return for sticking around. Keep in mind though that these were massive lawsuits that could have destroyed the companies. If you were a buy-and-hope investor in Philip Morris, you had to keep it together while you watched your investment take a nosedive, sometimes more than 50 percent, when the lawsuits started to heat up. To compensate you for this volatility, Philip Morris raised its prices and continued to pay shareholders a large part of the profit in the form of dividends.

fundamentals Also called "funny-mentals," referring to the analysis of the actual business as opposed to the stock price, stock chart, or hot tip found on the Internet. Fundamentalists, those who invest based on fundamentals, will go on and on about how their company is great and profitable in response to why the stock price fails to go up. Their counterparts, simply known as "mental," will suggest a hot stock needs no profits, which explains how a stock grows into a bubble.

Figure 1.1 Philip Morris Performance 1970–2010

In turn shareholders had to have the guts to reinvest those cash dividends and buy more Philip Morris. This is the rub. That compounded 17 percent return was only achieved if you reinvested the dividends each quarter (Figure 1.1). Is it reasonable that you might have been tempted to take the money and run? If you did you missed out. My point is simple. It is hard to think through how history will be written, and long-term investing finds success in unusual places.

So, how did they really do it? Philip Morris started to diversify the profits not paid out in rich dividends to buy up food companies. This should have been obvious, as the company was simply buying more things people used every day. Turning the company into a conglomerate allowed Philip Morris to diversify its holdings, lower its risk, and increase returns to shareholders. At least that was the idea. In 1988 Philip Morris acquired Kraft and became the largest cheese maker on earth (Figure 1.2). By 2007 Kraft was spun off as a separate company. This was but one acquisition that Philip Morris made over the years, but gives you an idea of the buying and selling of other assets that contributed to the outsized returns of the firm.

While the domestic tobacco business is dying off, literally, we export our cancer internationally to keep up profits. In 2008 Philip Morris, which changed its name to Altria Group in 2003, spun off Philip Morris International. Notice they kept the name for the foreign

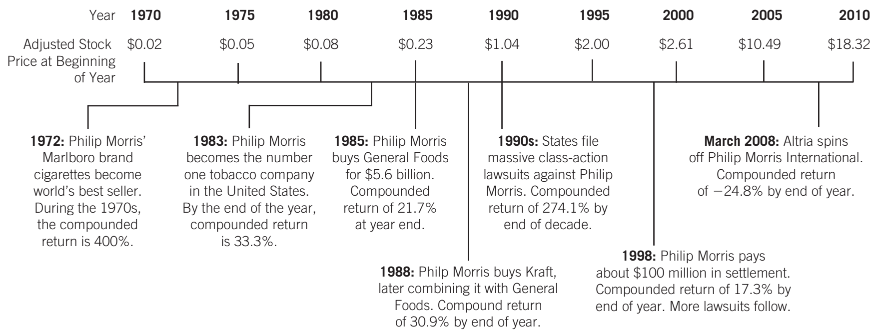

Figure 1.2 Philip Morris Timeline 1970–2010

population. I guess there is still a strong demand for the Marlboro Man abroad. In the end perhaps you could have seen all along that Americans would keep smoking, profits would be diversified into cheese makers, and states would be given incentives to keep Philip Morris alive to pay off billion-dollar settlements. All of this would end with the idea that our glamorized culture of smoking would have appeal to emerging economies as they earned enough money to buy a pack of reds. This is just not the bet I want to try and figure out.

Disneyland Adventure Kills Wall Street

Everyone needs a little fantasy to escape the day-to-day grind. In my profession, finance professors love to offer high-minded examples of what-if scenarios in order to prove their pet theory at the time. One of the classic examples is taking a select group of stocks and reinvesting the dividends over time in order to show amazing results for a buy-and-hold strategy. Not to worry, when the stock market hits the wall, the same examples are given with U.S. Treasury bonds showing how they would have done better during a specific period of time. Let's have some fun.

It's 1970 and you decide to take the kids to Disneyland. The place is packed and the stock market is coming off the highs of the last year. During the 1960s the stock market did fairly well, more than doubling in the last decade, but in 1969 it was down 8.5 percent. Today you will take the pulse of the American consumer and look for companies that are ripe for buying. This is a long-term investment project, so you are not worried that 1974 will wipe all of your profits out. Hey, you can't predict the future.

(*Continued*)

First off you buy tickets to the Magic Kingdom, which are not cheap. After paying the piper the kids want a Coca-Cola, which has a soda monopoly inside the park. Your kids immediately hop on Mission to Mars that utilizes computer technology by IBM. During the ride you sit outside and have a smoke break, lighting up a Marlboro made by Philip Morris. Once the kids get out, Mickey Mouse appears and a camera using Kodak film captures the precious memory.

After getting back home, with what little money you have left, you decide to purchase these five stocks and hold them because this is the *future* (and so can you!). And because you were in the Magic Kingdom, you somehow manage to invest all of your dividends and don't have to pay any tax on them, mainly due to pixie dust provided by Tinker Bell. Let's look at how the fantasy works out.

1970–2010 Results

After visiting Disneyland in 1970 with your children, you divide your remaining $100 evenly among five stocks, investing $20 in each one (Table 1.1). You do the math and call your broker on January 2, telling him you want to buy 35.71 shares of Disney, 2.74 shares of Eastman Kodak, 3.42 shares of IBM, 37.04 shares of Coca-Cola, and 1,000 shares of Philip Morris. (It's a magical world, so you're able to buy a fraction of a share.) Your broker's a really nice guy so he doesn't charge you any commissions for this trade, although in the real world you would have had to pay him a commission. You also discover that you can reinvest your dividends without paying taxes. "Groovy," you say to yourself as you enter a magical investing fantasy.

Table 1.1 Number of Shares Purchased on 1/2/1970 (Adjusted Closing Prices)

	Disney	Eastman Kodak	IBM	Coca-Cola	Philip Morris	S&P 500*
Invest	$20.00	$20.00	$20.00	$20.00	$20.00	$100.00
Price	$0.56	$7.29	$5.84	$0.54	$0.02	$85.02
Shares	35.71	2.74	3.42	37.04	1,000.00	1.18

* S&P 500 is treated as an imaginary no-load index fund priced at the index value.

You sell your shares on December 1, 2009, just in time to go holiday shopping. Your $100 investment has grown an astonishing $21,628.91, or 217.29 times your original investment! Forget that you didn't pay tax on the reinvested dividends or capital gains on the money—this is your fantasy and if these assumptions are good enough for finance professors selling books, it's good enough for you. Then you look back and wonder how much you could

have gotten if you would have invested in the S&P 500 index (Table 1.2). If you would have bought the index and held it for the same time period, reinvesting all of the dividends, you only would have earned 1,211.57 percent. Not bad for 13.12 times your original $100 investment. But you only would have ended up with $1,311.57!

Table 1.2 Performance 1970–2010

	Stock portfolio	S&P 500*
Average monthly total return	1.13%	0.54%
Total return 1970-2010	21,628.91%	1,211.57%
Value in 1970	$100.00	$100.00
Value in 2010	$21,728.91	$1,311.57

* S&P 500 is treated as an imaginary no-load index fund priced at the index value.

But Wait There's More!

It's 1990 and your kids are older and grown up. They're all broke except for your son Cornelius, who wants to start investing like you did back in the day. Disneyland is certainly still around. Coca-Cola is still the preferred drink of the Magic Kingdom. Digital photography has not yet overtaken film. IBM miraculously has survived the death of mainframes and the birth of PCs. Since you smoked, there's a high likelihood that your children do as well.

Cornelius does the same thing that you did back in 1970. He invests $100 in these five stocks (and the results are going to be pretty good). Why only $100? It is 1990, and Cornelius is juggling debt, a mortgage, and still has to pay off his student loans to clown college. If it were 2010 he would be living at home begging you for the money. Only this time around, taxes can be avoided by investing in an IRA. By 1990, the wind is really at his back, because trades are cheaper from discount brokerage firms that didn't previously exist, he can defer taxes because IRAs existed after 1974, and it's easier to get the information to back-test investments, even before the Internet was widely used.

1990–2010 Results

In 1990, Cornelius calculates that with his $100 he can buy 2.76 shares of Disney, 1.23 shares of Eastman Kodak, 1.18 shares of IBM, 3.45 shares of Coca-Cola, and 19.23 shares of Philip Morris (Table 1.3). Just like you, his broker doesn't charge him any commissions. He doesn't have to pay any taxes when he reinvests the dividends because he's going to use an IRA. "Radical, this is closer to reality TV than Dad's stupid fantasy," he says to himself.

(*Continued*)

Table 1.3 Number of Shares Purchased on 1/2/1990 (Adjusted Closing Prices)

	Disney	Eastman Kodak	IBM	Coca-Cola	Philip Morris	S&P 500
Invest	$20.00	$20.00	$20.00	$20.00	$20.00	$100.00
Price	$7.24	$16.22	$17.01	$5.79	$1.04	$329.08
Shares	2.76	1.23	1.18	3.45	19.23	0.30

Cornelius is disciplined and he doesn't sell his shares until December 1, 2009, when he has to hit the malls to shop. Looking at his performance statement, he sees that his five stocks returned 680.85 percent (Table 1.4). His $100 has grown 7.81 times its value to $780.85. Like you, he decides to look and see how he would have done if he had invested in the S&P 500 over the same time period. Doing the math, he figures out that his $100 only would have grown to $338.85. That's a 238.85 percent return, or 3.39 times his original investment.

Table 1.4 Performance 1990–2010

	Stock portfolio	S&P 500
Average monthly total return	0.86%	0.51%
Total return 1990-2010	680.85%	238.85%
Value in 1990	$100.00	$100.00
Value in 2010	$780.85	$338.85

Is the Fantasy Waning?

It is hard to tell when experimenting with the same ridiculous hindsight setups that academics use to prove whatever point their research paper is trying to prove. What I am suggesting is simple. There is evidence—no matter where you look—that the big gains off the *super cycle* of the baby boomers of the United States are looking weaker going forward.

Time Is Not on Your Side

Over really long periods of time the capital markets—also known as the stock market—will grow. But, if you start at the wrong time, it could be a disaster. Even during a great century, there have been some bad times to buy a cross section of securities. Understand that

super cycle Technically an awesome bicycle you had as a child. It is also used as a slang term for a long economic cycle and is generally used to scare investors about any form of impending doom. Most recently, it's been used to describe the persistent increase in commodity prices. Super cycles are excellent sales tools due to their ultra-long time frame, allowing one to keep preaching a story regardless of the current environment.

Yes, you can chase China's growth or hot sectors like foreign search engines or social networking firms. The bottom line is too many people have too much information and all want the same thing—returns that are better than their peers. Put it this way. If more and more people get in the game, there is less for each person to take. The pie can only get cut up so many times. What is worse, the pie may not get bigger as more people take a slice. Nobody knows the future of investing, but as long as electronic trading lowers the barrier to entry, an endless stream of better players will look to take a piece of the action. At least the price of admission to the Magic Kingdom has only increased about 15 times since 1970, not the 60 times increase of the company's stock. The S&P 500's 12 times return would have left you a few bucks short of a ticket.

we are not talking about a single stock, but the market as a whole. Investing for the long term means you have to keep your money in the market and not take it out. Do you have the stamina to ride things out for 40 years? Remember to ask yourself, where are the Dutch, or where are the Romans? Do you think everything will just continue onward like it was over the last 100 years? If you have a long enough period of time you will make money, but if you think the next 40 years will be good you're betting that the next 40 years will continue to see the rise of the American economy. It's certainly not based on the rise of the Dutch Republic. There came a point even for the incredible Dutch East India Company that the luck ran out. By the time the New York Stock Exchange had a rented room to trade securities in back in 1792, the Dutch multinational was two years from being nationalized and on the way to liquidation. Do you want to start investing for the long term with a buy-and-hold approach during the last 50 years of the American Empire? There are a lot of parents and grandparents alive today who invested in the best 50 years of America, which was the last half of the twentieth century. If you're in the market for the next 10 years, good luck! You will need it. Most of the numbers that back up academic research

on market returns show that only over a 30- to 40-year period will you be assured investing success no matter when you start. Consider how wonderful the last 50 years have been in America. Can it repeat? Most of my clients will need the next generation to bear witness to how things will turn out. If you want to beat the system, you need to have a healthy respect for the time you have and then invest accordingly. Let's go through three scary scenarios that will bring the idea back home. Then we can go forward with an attitude of self-preservation, not cheerleading.

Welcome Home, G.I.

It's 1950 and you have $10,000 to invest. Maybe you worked for it, and maybe you inherited the money, but you have it and want to set it aside for the long term. The war is over and confidence is returning to the global markets 20 years after the 1929 stock market crash. Your stockbroker sells you a *mutual fund*, or more likely a collection of stocks.

There was no way to invest in something that tracked an index at that time. You get the advice of buy and hold, which is fine since the 1929 crash is ancient history. Reinvest every dime and you will be healthy, wealthy, and wise.

By 1972 your $10,000 investment has grown to $175,160 after an impressive 18 percent increase that year! You read in the newspaper about how the S&P 500 only grew 3.56 percent in 1970, so this year you feel like you're in good financial shape. All those years of reinvesting dividends since 1950 is starting to work out as retirement is looking closer to a reality. Come 1973, the S&P 500 is down 14.31 percent, and your investment has lost about $25,000 in value. It was a bad year for the stock market, but the worst of it has to be behind us, you say to yourself. Unfortunately for you, 1974 was an even worse year for the S&P 500, falling 25.9 percent. Your investment is now worth a little over $111,000, the same level it was at nine years ago! Either you're going to need to keep working, or your retirement life

mutual fund A magic box that creates fees for Wall Street. Generally known as a professionally managed pool of money that invests in stocks and bonds. Mutual fund industry growth is one of the few charts that only go up. Currently, there are more mutual funds in America than there are stocks on the NYSE.

is going to be a little leaner than you had hoped it would be. What could work against you at this point is the fear of losing more money, dumping out right at the moment you need to stay in. Even if you stayed in the game and reinvested dividends, your portfolio would not start growing past the 1972 value until 1979. The high inflation rates of the late 1970s would rattle any investor, let alone someone who was getting ready to stop working and live off of their nest egg when prices are jumping up each year.

Bell Bottoms and VW Bugs

So you escape the 1973 to 1974 bear market with money to invest. Being young and enterprising you may have made money selling VW bugs during the Oil Embargo of 1973. Or, you could have recently sold a store that sold clothes to hippies and saw the writing on the wall before disco broke out. Both were good moves, but now there is money to invest and a future to save for. It is 1976 and you have $25,000. This time you can take advantage of buying the market as a whole, or maybe you still want to buy some stocks. What could go wrong now that the second worst bear market in the last 100 years is behind you? You've read about the S&P 500's 37 percent return last year, so you're ready to invest, and you're mentally prepared to buy and hope for a nice return in the long run. You're also planning to retire in 25 years, so you pat yourself on the back for being smart and thinking ahead.

By the end of the 1980s cars and music have culturally both gone down the tubes, but your $25,000 investment has grown to $179,912. The 1980s were a great decade for stocks, and you're hoping things will keep going like this through the 1990s. It turns out that the 1990s are even better than the 1980s, and at the end of 1999 your investment is worth more than $945,000! Rock has revived itself and Ferraris now start up in less than half the time. In short, it is a miracle. After a decade of hearing about how you would need to learn Japanese, now the mantra is all about the "Interweb" and the "www." You never thought you'd have this much money, and the more cautious side of you is starting to wonder how much longer this will last. But don't think too much about that, you tell yourself; you're in it for the long run. You're disappointed in 2000 when the S&P 500 drops 9.03 percent, but you remember how far you've come, so you try not to worry too much about it. You've

always heard that it's bad to sell when the market goes down, so you decide to sit on your index fund, letting it grow. Since you are the buy and hold type, you never got involved in buying the tech-heavy Nasdaq Index. Avoiding fads has worked out so far. The S&P 500 drops another 11.85 percent in 2001, and then 21.97 percent in 2002. Your heart sinks when you find that your investment is now worth just $591,546. You were supposed to retire with that money! What are you going to do now? Hope that it goes up 75 percent next year? The next example will illustrate your wait time.

Knight Rider Crashes

After avoiding the horror of the 1970s stock market gyrations it seems like the worst may be over. While inflation is at a fever pitch, the market returned more than 18 percent in 1979. You inherit money from a rich uncle that made his fortune selling disco albums before an untimely death on the dance floor of Studio 54. It's 1980, the market is still cheap, and you have $40,000, so you buy an *index fund* that tracks the S&P 500.

Five years later you have more than doubled your money with $103,000 in your account. You think about spending the money. How about buying a 1985 Pontiac Trans Am so you can pretend you're David Hasselhoff driving around KITT, the famous talking car from the 1980s TV series *Knight Rider*? Okay, that may have been my personal fantasy in 1985, but you get the picture. You decide that it's better to have a comfortable retirement than Hollywood dreams. After all, you're in the stock market for the long haul.

By the end of the 1990s, your investment is worth more than one million dollars. After considering using the money to buy a new house, you get a mortgage and let the portfolio continue to grow.

index fund A mutual fund that seeks to track the performance of a market index (e.g., S&P 500). Developed in 1973, index funds provide investors a way to trade broad indexes. Professional investors use index funds to capture the performance of a broad market without the cost of buying hundreds of stocks. Charlatans have been known to create mutual funds that try to beat the index, but are in fact simply "closet index funds." The most popular index funds are Exchange Traded Funds. See Chapter 8.

Between 2000 and 2002, the dot-com crash leaves you with just less than $651,000, and you're fuming. You had one million dollars just a few years ago! You tell yourself that you'll wait until the end of 2008 to retire, which should give you some time to get that money back. At the end of 2007, your investment is worth almost $1.2 million dollars, so you're not worried about retirement anymore. You remember back a few years ago after the dot.com crash, how you were down and out at just more than $651,000, and now you're sitting pretty. But wait a minute. Shouldn't you have more than $1.2 million? In 1999, you had just over one million dollars in the index fund. It's almost 10 years later and you've only gained about $200,000, or 13.72 percent. Looking at your statements, you earned 15.61 percent last year! Your head starts to hurt. Has the market gone nowhere since the beginning of the decade? Little did you know that next year, in 2008, the S&P 500 would plunge 36.58 percent. Out of frustration, you sell all of your shares at the end of the year for just more than $750,000. Looking at your statements from 1997 and 1998, you realize that you had about the same amount of money back then. Where did it all go? Aren't index funds supposed to be a good investment?

My Dinner with Burton

It was November of 2008 and I was invited to a due diligence conference in Boston. For those outside the Wall Street system, this is an event where a company flies you someplace nice and warm to hear them pitch a story under the cover of *education*. It was winter in Boston—you had to want to go to this one. My main reason for leaving the relatively decent weather in New Mexico was to hear Dr. Burton Malkiel speak. You may not know the name, but this guy is a legend in the business. An academic from Princeton, he wrote an amazing book called *A Random Walk Down Wall Street*. For years I hated this book with a passion. The bottom line, he says, is that you should simply buy and hold index mutual funds. How is this helpful to a guy like me who makes his money trying to beat the index? I was ready for a fight, or at least to have the opportunity to prove something to the guy who said my entire life's work was for nothing.

I arrived late, notably because I was talking with Dr. Andrew Lo, the guy who taught me risk budgeting and the basis of the work we do at my firm. Walking through the banquet door were no more

than 150 top movers and shakers in the adviser world—a small group for the level of the speaker. I knew I was here because somebody thought I had a chance in this industry, or they just wanted to sell me their products. More likely it was the latter. There was only one table with a few empty seats. I sat down and introduced myself to the other guests. To my utter terror I realized I was sitting next to Burton himself! No, I didn't know what he looked like. Quickly after the introductions, the host started talking and I just sat there quietly. Once Burton took the podium there was a flurry of notes written on the back of every cocktail napkin I could get a hold of. He was wrong! His whole talk referenced the timing of the current global crisis, opportunities to make money on the panic, and his views of China. I knew I had this guy and I was going to expose him for not following his own rules. After working myself into a fever, the talk ended, the applause subsided, and the perfunctory line of glad handers and questioning began. I waited until most of the people had cleared out before I came into the kill zone.

Burton knew before I started talking what I wanted. I said clearly, you seem to think that is possible to beat the index—tell me I am wrong. He was cool, calm, and collected. He said if you are above average and have a little luck you can outperform any benchmark, and he wasn't even trying to get rid of me! We talked for a while about my style, and he encouraged me to keep trading and create a long-term track record. His message was simple—most people, statistically, can't beat the markets. Everyone can't win, right? Since most investors don't have the time or skill to dedicate their lives to this ridiculous game, how else can I outperform unless they underperform? He had me and knew it. His tips were simple: find markets that are less picked over, more illiquid, and most importantly, inefficient.

Before he moved on, I asked how he made his money. Simple, he said: book royalties, warehouse properties (getting 8 percent and more at the time), and small cap Chinese stocks. This was it! I thanked him and told him I was going to go home to my wife and tell her it was okay that I didn't buy and hold, and Dr. Burton Malkiel approved this message.

I left the banquet room knowing one thing: Forget what they say, watch what they do. Burton wasn't an index investor; his money was in peddling ideas. He admitted that there could be some inefficiency and to this day he remains the chief investment officer

of AlphaShares Investments, pushing China as the growth story of the world.

Now that the boogieman was confronted I could move on to greener pastures. There was no random walk, rational world, or anything else that could convince me that buy and hold would ever work. I was free. I started to look at the other guys that have espoused the buy and hope, the "you can never beat the market so join it" clan. Dr. Eugene Fama was the next person to track down. After reading through his works, many which are required reading for the Chartered Financial Analyst (CFA) examinations, I came across a simple truth: Fama is in the business of selling mutual funds. His firm, Dimensional Fund Advisers, or DFA, ran more than $200 billion in index funds as of 2010. These guys practically invented the market. Every stone I turned revealed the same story. Even in academia the game is rigged—they want your money.