Chapter 1

Risk

COPYRIGHTED MATERIAL

It is a dirty fact, but everyone on Wall Street knows the stock market could not function without Dumb Money. Dumb Money—and that is how Wall Street classifies outsiders—always does what most benefits Wall Street. Dumb Money buys stocks when it should sell, and panics and sells when buying makes more sense. This is a primary reason why Wall Street makes so much money when most everyone else fails, or inches forward, in the stock market. If not for the positive effect of inflation, and corporate stock dividends, which represent more than 45 percent of historical stock gains, most investors would have sharply smaller investment portfolios.

Now, as Baby Boomers confront retirement, and younger generations worry they will not live as well as their parents, millions of people are beginning to understand that they must get much smarter, much faster, about the stock market if they ever want to retire, pay for their children's college educations, or lead lives that eventually bear some semblance of financial ease.

The old ideas of coasting toward retirement by regularly investing in stocks and effortlessly doubling stock portfolio values every seven or so years as the stock market advanced are no longer valid. The Credit Crisis of 2007, and Europe's sovereign debt crisis that sparked in 2009, have unleashed new financial realities that are likely to prove true Wall Street's adage that the stock market hurts the most people, most of the time.

Yet, the future need not be as difficult as the recent past.

A well trod path exists that anyone can follow to better deal with Wall Street and the stock market. This path has quietly existed for centuries. The path was carved out, and continually refined, by a small group of people who typically avoid the financial calamities that ensnare everyone else. This group of investors has historically dominated the financial market, and quietly snickered at the widespread idea, birthed in the late nineteenth century by John Stuart Mill, that people can make rational financial decisions.

Mill called his idea *Homo economicus.* He declared his Economic Man capable of making decisions to increase his wealth. Mill's man has persisted ever since like some financial Frankenstein even though the financial markets are so complex—especially in the past 40 years—that it is increasingly apparent that Mill's man, today known simply as John and Jane Investor, has great difficulty profitably navigating the stock market.

In sharp contrast to Mill's incarnation is a small group of people who make more money than they lose. In keeping with Mill's use of Latin, think of people in that group as *Homo Indomitabilis*.

The Indomitable Man is different than everyone else in the market. He leads a life of counterintuitive thought and action that is perhaps best summed up by a simple idea: Bad investors think of ways to make money. Good investors think of ways to not lose money. Those 17 words are the most important words any investor can know. Learn the meaning of those words, and you have a chance of real success in the stock market.

The difference between the idea of the good investor and bad investor is profound. One idea ensures you eventually give back profits, and likely some, or all, of your initial investment, to Wall Street.

The other one lets you keep much of what you make. Though the good investor rule seems like common sense, it is not well known off Wall Street. This is one reason why so many people fail in the market, or are swept along with the crowd, because they lack a simple, proper, disciplined framework to make investing decisions. Most people are interested in getting rich, and getting rich fast. They try that approach again and again and again, often taking on more risk to make profits and recoup losses. Often, this ends poorly. Still, they continue to climb back up the stock market's risk ladder, chasing the higher returns of riskier investments without truly understanding the risks they are taking, or even why they failed.

The issue is not necessarily that people are too greedy for their own good, or not smart enough to understand how to navigate the stock market. The issue is that the United States very quickly morphed from a nation of savers to investors. People who once saved money in passbook savings accounts have since the mid-1970s been increasingly thrust into the stock market—even though they were, and often remain, effectively financially illiterate. These new investors use ideas that work on Main Street—but not Wall Street. The disconnect is now lethal. Rather than simply hoping the economy improves, or that another bull market erases people's financial problems, it is better to focus on the facts and ideas on Wall Street that are made truer by time, and that have long kept the best investors safe when others have stumbled.

If you think people learn anything from losing money, you are wrong. The people who lose the most money, at least in the stock market, are often the most anxious to recoup their losses. The reasoning is fascinating, and it is a key to understanding why investors are stuck in a boom-and-bust cycle. "If someone had a lot of money in the market, and then loses it, they respond by jumping back into the market because the risk of not making money is greater than the risk of losing what they have left," says Mark Taborksy, a former portfolio strategy chief at PIMCO, one of the world's largest money-management firms, who now works at Blackrock, another major firm.[1]

Gib McEachran, a financial planner in Greensboro, North Carolina, regularly deals with investors who have fallen off the risk ladder, and are

eager to get back on. In late 2009, a retired couple with a $1.6 million investment portfolio came to his office for help. At the height of the Internet bubble, the couple's account was worth $2.3 million. Rather than focusing on how the money could be managed to provide them with retirement income, the man, a former engineer, wanted to know how McEachran would recoup the lost $600,000. His wife eventually told him to be quiet and listen. (Women, studies show, are more risk averse than men.)[2]

Even though there is so much anger toward Wall Street in the wake of what is now called the Global Financial Crisis that started in 2007, and that is now enveloping Europe, there is no escaping the market—only learning how to deal with it. But before learning how to deal with the market, it is important to understand how Wall Street came to Main Street.

A Nation of Stock Market Junkies

America's relationship with the stock market is actually a relatively recent phenomenon that took off in the 1990s when technology accelerated, automated, and coalesced major policy developments that had occurred over the preceding 15 years to let Wall Street invade Main Street. In isolation, none of the events seem epically important, but the sum is greater than the parts, and the succession of events, and scope of innovation, are stunning.

In 1974, the U.S. tax code was changed to create Individual Retirement Accounts (IRAs). The launch of IRAs let people invest in stocks and defer paying taxes until the money was withdrawn at retirement. This provided many people with their first taste of investing and sent millions of investors climbing up the risk ladder. The launch of the IRA also marked the end of a bear market. The next year, in 1975, the Securities and Exchange Commission (SEC) deregulated brokerage firm commissions, ending a 183-year-old practice that had protected the profits of stock exchange members and kept investing beyond the reach of many because stock trading commissions were exorbitant. Soon, discount brokerage firms, including Charles Schwab, brought

Wall Street to Main Street. To attract customers, Schwab and others dramatically lowered stock-trading commissions. Suddenly, stock trading was affordable to the middle class.

"With the sudden arrival of negotiated stock trades that were less than half the cost they had been, a major barrier to investing went away for the average American," Charles Schwab, the brokerage firm's founder, said.[3]

According to Schwab, in 1975 about $1.75 trillion of investable assets were held by individuals, and less than 45 percent was invested in securities, like stocks. Trading commissions were fixed-price and done through highly paid brokerage firms. By 2005 individuals held more than $17 trillion of investable assets, and 73 percent was invested in securities. In just 30 years, more than half of the U.S. adult population owned stocks in one form or another.

In 1975, John Bogle launched the Vanguard Group. His mutual-fund company is to Wall Street what Walmart is to retailing: low-cost. Around 1980, Ted Benna, a tax consultant, effectively created 401(k) retirement accounts that would prove to play a major role in how people saved for retirement.

Inevitably, investors who got a taste of the market in IRAs and 401(k) accounts, found they loved stocks. A massive bull market began in 1982, two years into President Reagan's first term. Conditions were ideal. It was cheap to buy stocks. It was easy to do. It was tax effective. Standing on the sidelines was inadvisable, and maybe even dumb, as the Dow Jones Industrial Average's rally would soon demonstrate. On August 12, 1982, the Dow Jones Industrial Average was at 777. The rise of the stock market would soon be chronicled in Technicolor. In 1989, CNBC was launched, which would ultimately help change the public's perception of the stock market. Prior to CNBC's launch, financial news was mostly limited to the business press, including the *Wall Street Journal* and *Barron's*. If the stock market was mentioned on TV, it was only to briefly note that the Dow Jones Industrial Average had risen or fallen during the day. Now, stock market news often dominates evening newscasts, and the front pages of many newspapers and magazines.

On Christmas Day, 1990, the Internet was effectively launched, unleashing forces that quickly revolutionized stock investing. The stock

market was suddenly accessible to anyone, anytime. Buying stocks was destined to be as easy as clicking a computer mouse. In 1993, the first exchange-traded fund, the SPDR S&P 500 Trust (SPY), was created. Exchange-traded funds (ETFs) are stocks in drag. They trade like stocks, but own a portfolio of stocks like mutual funds. In 1995, as the stock market chugged higher, Dick Grasso, then chairman of the New York Stock Exchange (NYSE), let the first reporter in the Exchange's long history report live from the trading floor. Soon, reporters from all over the world joined CNBC's Maria Bartiromo at the Big Board. In 1999, the United States Congress eliminated the historic separation of investment and commercial banks, enabling the creation of mega-banks, like Citigroup and Bank of America. The late 1990s were heady times on Wall Street.

In April, 1999, the predecessor of TD Ameritrade, an online discount brokerage firm, introduced its now classic Stuart advertising campaign, and other firms followed with similar campaigns that suggested that making money was easy—and fun. Few ads captured the zeitgeist like Stuart.

Stuart was a young dude with spiky, punk rock hair and some vague office job. One day, he was copying his face on the office mimeograph machine when he was interrupted by his boss and summoned to his office. Rather than getting disciplined, the boss asked Stuart to teach him how to buy stocks on the Internet.

"Let's go to Ameritrade.com," Stuart tells his boss. "It's easier than falling in love. What do you feel like buying today, Mr. P.?"

He buys 100 shares of Kmart.

"What does that cost me?"

"$8, my man."

"My broker charges me $200 for this trade."

"Ride the wave of the future, my man."

And what a wave it was. By January 14, 2000, the Dow Jones Industrial Average peaked at 11,722.98, a gain of 1,408.7 percent in 18 years. The nation was hooked on stocks. The advance was historic. Many people effortlessly made money. And then the Internet bubble burst in 2000. But before anyone could ponder what had transpired,

the Dow Jones Industrial Average delivered what was then its biggest one-day gain in history, rising 499.19 points on March 16, 2000. Naturally, many people concluded it made sense to stay in the market because the stock market had snapped back.

Amidst those wild gyrations, corporations were changing employee retirement programs. The now ubiquitous 401(k) accounts increasingly replaced pensions plans that had once guaranteed reliable retirement income after long careers. Consider IBM, whose actions are watched all over the world as a sign of how to best run a business. IBM radically changed employee retirement plans in 2006. The pension fund, which four years earlier had faced a $3 billion shortfall, was eliminated before IBM's corporate debt rating could be lowered by credit-rating agencies which would have increased the interest rates IBM had paid to borrow money. Like so many other companies, IBM shifted almost all of the retirement-plan responsibility to employees. Rather than retiring with a pension—a common benefit still enjoyed by many senior executives throughout corporate Amerca—IBM employees now invest in stock and bond mutual funds offered through the company's self-funded 401(k) retirement plan.

Kraft Foods, another major company, spent $20 billion in 2010 to buy Cadbury and create a global food beverage and candy company. But Cadbury's employees were told salaries would be frozen for three years if they did not give up their pension funds.

These changes highlight the often harsh realities of the global market, and the stock market's rising importance.

Calm Words for Wild Times

All good journeys need a tour book to help travelers make sense of the trip. The stock market's tour book was written at America's top universities. Though the ideas are rooted in complicated mathematical formulas, the conclusions are easy to understand, even during a financial crisis. The key principles are: Don't worry about stock market fluctuations. Don't try to predict the stock market. The market is volatile, but it rewards the patient and the faithful.

In 1965, long before the cult of equities swept the United States, Eugene Fama was completing his doctoral dissertation at the University of Chicago. Though he remains largely unknown off Wall Street, Fama's insights into the stock market helped give rise to the idea of buy-and-hold investing. Fama popularized the idea that the financial markets are efficient, and that it is difficult, if not impossible, for investors to beat the market. The Efficient Market Hypothesis (EMH) was the subject of his doctoral dissertation at the University of Chicago, where he still teaches. The central idea is that stock prices reflect all known information about stocks. His market was filled with "rational, profit maximizers," which perhaps was true before technology and tax code changes opened the market to Main Street. Because the stock market is a discounting mechanism, always reflecting future outcomes, Fama believed that there was no way, aside from luck, to outperform the stock market. He was nominated for the Nobel Prize in Economics in 2003. He was not chosen, but many consider him the father of modern finance.

His ideas ultimately found expression as buy-and-hold investing, which has been lustily embraced by the mutual fund industry and the parts of Wall Street that interact with Main Street. What business wouldn't want customers to always look past hardships, focus on the future, and most importantly never stop buying merchandise? Besides, many of the richest, most successful investors, were buy-and-hold investors. Warren Buffett, one of the world's richest men, was a long-term, buy-and-hold investor. Plainspoken, easy-to-like people like Buffett humanized investing by doing and saying things everyone could relate to. In 1989, another market spokesman, Peter Lynch, then manager of Fidelity Magellan, wrote *One Up on Wall Street*. In that book he introduced the idea of buying stock in things you know. His book was more nuanced than that, but the simple idea is what resonated. Clearly, Lynch's simple idea worked. He did great managing Fidelity Magellan's mutual fund, and everyone knew it. Anyone who invested $10,000 when Lynch took over Magellan, as the back of his book said, would have $180,000 10 years later—a 1,700 percent increase. Warren Buffett's results were better. A $10,000 investment in Berkshire Hathaway in 1964 was worth $80 million at the end of

2009. Of course, Lynch and Buffett are enormously skilled, and most people could not emulate what they do anymore than they could paint like Picasso or design computers like Apple's Steve Jobs. Therein lies the central problem facing most investors: Most people never think about investing in a meaningful way. Wall Street often seems intent against that.

Says Niall Fergusson, the financial historian: "Whenever I go to the Bloomberg studio in New York I seem to meet the same generic guy who has just called the bottom of the market yet again."[4] The generic man always urging others to be bullish, always urging other people to buy, is one of the stock market's timeless archetypes. You will never see a statue of him next to the famous Bull on Broadway in Lower Manhattan. He's too important to sit still. He always has a job to do, and stories to tell. He is always in demand to appear on TV, or dispense a quote or share some wisdom to help others make sense of the market. Many people reflexively accept those generalizations and rush headlong back into the market, scrambling up the risk ladder, to recoup their losses, and to make more money.

During the 2007 credit crisis, Linda Blay, a bookkeeper in Orange County, California, saw her investment portfolio lose about 30 percent of its value. By September 2009, some six months after the worst of the correction had ended, stocks were surging, and she was optimistic about the stock market. "It's got a track record," she said. "It outperforms any investment. I think it'll come back."[5] That, in a nutshell, is the hope and strategy of most individual investors, even though history shows such an approach is increasingly detrimental to their financial health.

On Wall Street, money takes the path of least resistance. Taking money from individual investors is the easiest way to make money. Dumb Money believes what it hears or reads.

"The plain truth," says Arthur Levitt, the former chairman of the Securities and Exchange Commission, "is that we are in the midst of a financial literacy crisis. Too many people don't know how to determine saving and investment objectives or their tolerance for risk. Too many people don't know how to choose an investment, or an investment professional, or where to turn for help."[6]

The most basic evidence of Levitt's lamentations is that many people repeatedly buy and sell stocks at the wrong time. They panic. They have no discipline. They have no investment style. They typically do not even understand the two primary schools of stock investing. To the amateur, value investing is buying a stock that pays a dividend, rather than finding a company that is trading at a discount to its intrinsic value. Such companies have a "margin of safety," three words Warren Buffett says contain the secret of sound investing. Growth investing, to most, is buying a stock that is rising, rather looking for companies with revenues and earnings growing faster than the market's average.

Meanwhile, Wall Street profits. Consider mutual fund growth rates. In 1960, investors had spread $48 billion among 270 mutual funds. By 2007, more than $12.4 trillion was invested in more than 8,000 mutual funds. By 2000, U.S. Federal Reserve data showed that nearly half of all U.S. households owned stock. From 1990 to 2000, the number of U.S. stockholders increased by more than 50 percent, a phenomenon described as one of the great social movements of the 1990s. From 1980 to 2005, the New York Stock Exchange's daily trading volume increased more than 3,400 percent, rising from 45 million shares to 1.6 billion shares. Over the same period, the price of a NYSE seat, which traders had to buy if they wanted to trade at the exchange, increased to $3.55 million from $275,000, up 1,191 percent.

The oft-overlooked consequence of America's reliance on the stock market is that every financial crisis impacts more people than the one that came before. The same is true if the stock market simply stalls, and people lose an all-important year of much needed investment gains. In 2010, the Standard & Poor's 500 Index was at almost exactly the same place it had been 12 years earlier. By 2011, not much had changed. The stock market ended 2011 at the same place it had begun. This makes learning to more effectively navigate the stock market, and trying to avoid future crisis, or at least minimize their impact, imperative.

Financial crises occur more frequently than is generally appreciated. The crises are stunning, not just because of the destruction caused by

the bursting of a bubble, but because of the psychology of the bubble. Every financial crisis hypnotizes millions of people into believing that the implausible is plausible. Want to buy a house with no money down and no credit check? Wall Street financed that dream, and made it come true (temporarily) for millions of people around the world from about 2002 to 2007. Want to invest in a new paradigm in which the old ways of thinking no longer apply? Wall Street spent much of the late 1990s selling investors shares of Internet companies with slick ideas and no earnings that would change the world. Even in the 1920s, unbelievably high interest rates could be earned loaning "investors" money to buy stocks on margin. The "investment" was considered low risk because there was little concern stock prices would stop rising. In 1635, Holland went mad for tulips and some "investors" bought bulbs for the price of houses.

Financial crises are a permanent, frequent part of the investing landscape. History proves that, and the future is unlikely to be different. Mohamed El-Erian, PIMCO's chief executive, sees a future of perpetual booms and busts that will occur every few years. He calls this the "new normal." He is so convinced the future will be turbulent that he and his firm are challenging the fundamental ideas that have long determined how money is invested. Rather than solely diversifying investments across stocks and bonds to reduce risk, a Nobel Prize winning idea that most everyone uses to temper investment decisions, El-Erian and his fellow fund managers first focus on risk, then reward. PIMCO has essentially created a mutual fund based on the good investor rule of always thinking of ways to not lose money. The fund picks investments based on risk factors. Stocks, for example, often behave like investment-grade corporate bonds. Junk bonds are often like small-capitalization stocks. PIMCO uses its analytical expertise to decide if bonds or stocks offer the better value. The entire portfolio is then hedged with Standard & Poor's 500 Index options and other such instruments to insure investors never lose more than 15 percent of their money during the inevitable declines that hit the stock market every few years.

If, by now, you are thinking of the best spots in your backyard for burying your money, hold off for a moment. While there is nothing

you can do to make the stock market a friendly, kind place, you can change how you approach the market. The *good investor rule*—thinking first of how to not lose money, rather than how to make money—is the critical first step. The second step is learning to understand the mechanics of the market. Think of the principles of judo. Size doesn't matter. Success comes to those who learn to take advantage of their opponent's weight. Well-trained judo fighters, no matter their size, regularly flip larger attackers. The same principles work for investing—but you use your mind and your emotions rather than your body. Think of Yoda, the diminutive Jedi master, from the Star Wars movies. In a sense, investors have to become like Yoda.

Some cynics would have you believe that these recent difficulties in the market, and on Wall Street, are insurmountable, and that people are trapped. They are not. Just ask Warren Buffett. "To invest successfully over a lifetime does not require a stratospheric IQ, unusual business insights, or inside information," Buffett says. "What's needed is a sound intellectual framework for making decisions and the ability to keep emotions from corroding that framework."[7]

Bernard Baruch, who sidestepped much of the Great Crash of 1929, knew it well. "To break free of this cycle of breakdown and build up, we must free ourselves of man's age-old tendency to swing from one extreme to another. We must seek out the course of disciplined reason that avoids both dumb submission and blind revolt," Baruch wrote in 1957. "It is not mere chance that whenever society is swept by some madness reason falls as the first victim."[8]

Though Baruch and Buffett belong to different generations, they are part of the long line of people in the market, those Indomitable Investors, who live by what Buffett calls "that framework." Now, let's see how the framework is built.