How To Get Out Alive – Part 3

Investing

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Once you have followed the principles of the first two articles in our series, you should be generating funds for saving and investing. The next question is usually where in the stock market to invest it. (For those of you who have already done some investing on your own, this seems like an especially pertinent question because you are probably angry and frustrated that you can't consistently "beat the market". You figure that, like in dental school, if you work hard, do extra cases, and stay up late, then you should gravitate toward the top of the class. After all, that is the American Way! So why doesn't that work with investing?!? Read on... It turns out that you may be trying to win a loser's game!)

Rather than ask "where" to invest, you should first determine "how" to invest. Let me explain. Whether you are a frustrated investor or simply have no interest in such things, you don't know it, but you probably subconsciously agree with the 95% of folks who think there are three places in the world where the stock market doesn't work: North Korea, Cuba -- and Wall Street. Say what?! I am getting ahead of myself. Time for an example.

What if you could bet on a football game between The Ohio State University and your local high school team? You don't have to be the head cashier at Wal-Mart to know the obvious bet is on Ohio State. Enter odds makers like Jimmy the Greek. Would you bet on the high school team if you got an extra, say, 50 points? 100 points? 150? There is some "point spread" that would make it an even bet. It could be that the consensus among all the professional odds makers is maybe 237 points. The actual outcome won't be exactly that number, over time, it is amazing how the spread works out. I'll bet you don't know anybody who *consistently* wins enough football bets to make a living at it, especially after the cost of playing - and losing some.

The stock market works in a similar way. If Home Depot is selling at $35/share, that means tens of thousands of professional money managers and analysts have decided that is the right price, based on all available information. If you - or an advisor you work with - think it should be $50 instead, then you are saying a lot of very smart people are wrong! Which means that you are saying the markets don't work...

You - or an advisor - may think that all the new internet tools and flow of information will give you a leg up as you *actively* try to beat the market. Remember, 80+% of all trades are done by professionals at institutions. They all have the same information - or better. All this information is said to make the markets *efficient.* Unless you have illegal access to insider information, the Efficient Market Hypothesis says that any information about a company (strengths, weaknesses, future prospects, etc.) are already reflected in the current price. For instance, the fact that the population is aging is not a secret and has already been factored in to the price of healthcare stocks. In fact studies show that significant changes in company information is reflected in its stock price in less than 40 seconds!

You may acknowledge that most folks can't beat the market, but your ego - or that of an advisor - makes you think that *you* are special and that you can make "active" investing work. (It's like Lake Woebegone where *all* the kids are above average!) we would all like to find a Tiger Woods of investing, but there are 20,000 Tigers out there, so you can't know which Tiger will win at any given time.

Some advisors give up managing directly, and they try to outsource the problem by becoming a "manager of managers". This doesn't overcome the Efficient Market Hypothesis - it may just add a fruitless layer of additional fees! For example, there is a study of the manager performance for the 230+ largest pension funds. They can afford to hire the best investment managers, the likes of which you and I will never have access to. Yet with all their horsepower, 93% of the time those managers failed to beat a *passive* basket of "index" funds that was 60%

stocks and 40% bonds (a typical allocation for large pension funds). And it was not the same managers in the 7% each year!

An "index" fund blindly buys every stock in a defined index, like the S&P 500. The objective is to be happy to accept a return about equal to the overall "market", or at least that index. This is the opposite of *active* investing. Part of the benefit is to keep expenses low, since there is not a lot paid for research, trading, etc.

The grandaddy of index funds is the Vanguard S&P 500 Index Fund. If you do your own investing, then you have access to this fund and others. However, indexing is only one form of passive investing. Some would say that blindly indexing is like "checking your brains at the door". For a very overly simplified example, suppose company #500 in the S&P 500 list was reduced to #501. Theoretically, to precisely match the index, the index fund would be obligated to sell that company and replace it with the new company. If the prior company became #500 in a few months, the index fund would have to buy it back. Why not have a simple rule in place that states that a company has to fall outside the index for, say, six months before you sell it. This would minimize the whipsaw effect. The more rules and filters a fund uses, the less it is like a pure index fund. However, the underlying fund philosophy is still passive. There are institutional funds, like those of Dimensional Fund Advisors, who use this approach and often outperform pure index funds.

Deciding between the active vs. Passive approach is just the first decision. Next you have to decide your risk/reward profile. You can't tell an advisor that you want 15% return but no risk! You have to choose whether you want to sleep well now or eat well later! Fact is, you have to balance short term risk with long term risk.

Statisticians and financial folk think of short term based on the standard deviation of volatility. I.e., what is the risk that your account will be down next Monday. Long term risk is more insidious and asks the question about whether you will have enough money when you retire. One of an advisor's main challenges is to help you make an informed decision to balance those two risks. Once you establish that profile (often called something like an Investment Policy Statement), that gives the advisor the direction he needs to manage your funds. His next big challenge is to help you stay the course as the inevitable ups and downs occur. (We find that everybody is a long-range investor - as long as the market is going up!) we facetiously say that we don't have doctors with investment problems. Instead, we have investments with doctor problems! You need to get out of your own way many times. For instance, we talk about the stock market averaging about 10% over time. Yet the average investor realizes less than one half that return on his own account. This is due to excessive trading or not being fully invested because they are trying to time the market or are off chasing the latest hot stock tip. It is imperative that you receive a quarterly performance report if you use a professional advisor. This is NOT the same thing as your monthly report from Schwab, Fidelity, etc. Rather, a performance report should show you a cumulative history or returns for 1, 3 and 5 years.

So, don't get caught playing the loser's game. It is the performance of your overall portfolio that counts. Not just a few hot winners. Those are for bragging rights at the study club!