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The Greatest Hits of Investing

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For more than a decade, I have had the privilege of hearing many colleagues discuss the fundamentals of investing in simple and effective ways. Everyone puts their own words and music to this set of ideas, but the following are what I consider the top ten greatest hits, with a few of my own verses added to the mix. Greatest hits aren't new, by definition; therefore, this article merely aims to chronicle and arrange them in a storytelling sequence, where one connects to the next, rather than in order of importance or priority. Trends change and fads come and go, but investing is like music in that true classics stand the test of time and remain relevant long after they were initially composed.

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1) CONVENTIONAL THINKING

Consider the questions people ask upon learning you are a financial advisor. "What stock should I buy?" is a common response. They want to know if you can help them discover the next Apple. Another frequent request is, "Where do you think the market is going?" They want to know if now is a good time to be invested in the market, or if they should bail out of stocks instead. If you have no answer, then surely you know a hot money manager or can identify the next Peter Lynch for them.

All these questions share something in common—you are being asked to make a forecast! Therefore, conventional thinking seems to be that, in order to have a successful investment experience, you must look into your crystal ball and predict the future.

2) MARKET FORCES

There is a completely different approach that all investors should at least be aware of, and it wasn't developed by the big banks and brokerage firms on Wall Street. It originated and evolved in the halls of academia and is based on a mountain of evidence showing that free markets work because the price system is a powerful mechanism for

communicating information. As F.A. Hayek pointed out in his Nobel laureate lecture, "we are only beginning to understand how subtle and efficient is the communication mechanism we call the market. It garners, comprehends and disseminates widely dispersed information better and faster than any system man has deliberately designed."[1]

What does this mean in the realm of fiercely competitive capital markets? Simply, that prices are fair. Competition among profit-seeking investors causes prices to change very quickly in response to new information, and neither the buyer nor the seller of a publicly traded security has a systematic advantage. Therefore, the current price is our best estimate of fair value.

3) JUST MY OPINION

Despite the strength of market forces, many investors may never lose the urge to form an opinion about the future, or to ask their advisor for one. However, if you choose to offer your outlook for the future, it should be followed by a reminder that you don't make investment decisions based on an opinion—yours or anyone else's. If the compulsion to act on an opinion is too difficult for your investors to resist, ask them if it is conceivable that they are the only one with the information upon which their opinion is based. If the answer is no and the information is widely known, then why wouldn't it already be reflected in prices? For example, the claim that "everyone knows interest rates are going up" should be met with the fundamental premise that if the statement were literally true, rates would have already gone up! The logic behind how markets work is a formidable response to any forecast of the future.

4) MAN VS. THE MARKET

Not only is this logic formidable, but the evidence supporting it is also compelling. If free markets fail, it would be easy for investors to systematically beat the market, but in reality, man versus the market isn't a fair fight and most of us should accept market forces rather than resist them. There is a large literature devoted to analyzing the results of professional money managers. It dates back over four decades to the original study of its kind conducted by Michael Jensen in 1968. The experiments have been repeated many times with better models applied to larger and more reliable data, but the results continue to confirm the original conclusions. As you'd expect, some managers are able to beat the market on a risk-adjusted basis, but no more than you would expect by chance.

Furthermore, it must be the case that, in aggregate, investors earn market returns before fees. This doesn't just hold over the long run, but at every instant due to the adding up constraint. The market reflects the collective holdings of all investors, so the value-weighted average investment experience must be the market return minus fees and expenses. This is not just a theory; it is a universal unconditioned truth relying solely on simple arithmetic.

This arithmetic leads many investors to think that, since money managers aren't like children from Lake Wobegon (who are all above average), a winning investment strategy attempts to identify above-average managers and avoid all the others. But can you systematically identify in advance managers who will outperform the market after adjusting for the risks they took? Although it is hard to imagine there aren't skillful managers, the challenge facing investors is that true skill is hard to distinguish from pure luck.

Identifying managers who have outperformed in the past is just as easy as looking up the scores from last night's sporting events, but there is very little persistence in the performance of managers and no documented way of determining who will outperform in the future. Most regulators require sales communications to contain the disclaimer that PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS with good reason. Regrettably this warning sign is treated like a posted speed limit and dismissed with flippant regularity.

This doesn't mean professional money managers are stupid! There are undoubtedly many smart ones who take their job very seriously and work hard to get the best results they can for their clients. But the market is hard to beat because there are so many smart managers—and not in spite of it. If you take the world's greatest bass fisherman to a dry a lake, he won't catch any fish. He's still the world's greatest bass fisherman, but that's beside the point if there isn't anything to catch.

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1. Friedrich August von Hayek, "The Pretence of Knowledge" (lecture to the memory of Alfred Nobel, December 11, 1974), http://www.nobelprize.org/nobel_prizes/economics/laureates/1974/hayek-lecture.html/ (accessed July 6, 2012).

5) EVERYONE CAN WIN

It is not necessary for someone to have a lousy investment experience for you to have a successful one. Everyone can win because with capitalism there is always a positive expected return on capital. The expected return is there for the taking, and as a provider of capital, you are entitled to earn it. That doesn't mean it's guaranteed to be positive, but only that it is always expected to be positive.

Realized returns are uncertain because the market can only price what is knowable. The unknowable is by definition new information. If it is considered bad news, or if risk aversion increases and investors require higher expected returns, then prices will drop. This is the market mechanism working to bring prices to equilibrium where, based on the new information, the expected return on capital remains positive and commensurate with the level of risk aversion in the market. The opposite would be true if the new information is considered good news or if risk aversion declines. This is how well-functioning capital markets maintain a strong and pervasive relationship between risk and expected return. There is no free lunch.

6) EXCELLENT VS. UNEXCELLENT

But stocks and bonds don't all have the same expected return. Conventional wisdom says that if you want better returns, you must uncover the limited number of truly outstanding companies. In other words, the stocks and bonds of these "excellent" companies, based on their superior fundamental measures (e.g., return on assets, earnings to price, etc.), should have a higher expected return than the stocks and bonds of "unexcellent" ones. While this implies an "excellent" company should pay a higher interest rate if it borrows money, intuition suggests that lenders will assess the strength and relative riskiness of borrowers and charge the riskier unexcellent ones higher rates. The same concept should apply in the stock market.

The market is a closed system where there must be a buyer for every seller and an owner for every stock and bond. There are no orphaned securities! It is mathematically impossible for investors to collectively limit their holdings to the stocks or bonds of excellent companies, so the riskier companies must offer an incentive for investors to buy (or continue to hold) their stocks or bonds over those of a safer company. The incentive comes in the form of higher expected returns. The market is not fooled, but rather, rationally pays a higher price for—and accepts a lower expected return from—the stocks and bonds of excellent companies, and vice versa. Therefore, the unexcellent company has what is referred to as a higher cost of capital, which is equivalent to the investor's expected return.[2]

7) EFFECTIVE DIVERSIFICATION

However, not all risks generate higher expected returns. Markets only compensate investors for risks that are "systematic" and cannot be eliminated. For example, the Green Bay Packers won't pay Aaron Rodgers more money to play football without a helmet. It is a risk that can easily be avoided if he puts on his helmet and buckles up the chin strap! Similarly, investors shouldn't expect an additional reward for taking the risk of concentrating their portfolio in a few securities, industries, or countries because the increased risk of doing so is easily eliminated through effective diversification.

To diversify effectively, investors allocate capital across multiple asset classes around the globe to suit their unique circumstances, financial goals, and risk preferences. Ineffective diversification, on the other hand, includes concentrating a portfolio in a few securities, diversifying by broker, or dividing up assets among money managers in an uncoordinated way that does not eliminate risks they shouldn't expect compensation for bearing.

8) MORE THAN A MAP

Travelling the road to a successful investment experience requires more than just a map. Building a portfolio that puts these ideas to work is one thing, but staying on route is something else altogether. Keeping your hands on the wheel and your eyes on the final destination requires the emotional discipline to execute faithfully in the face of conflicting messages from the media and the investment industry.

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2. The excellent vs. unexcellent example provides a simple explanation of pricing (i.e., expected returns) based on risk, but risk is technically not that of the company by itself but of the company in the overall portfolio. For example, if you are a bank and have loans to many excellent companies in the same industry, you may lend at the same rate to an excellent company in the same industry or an un-excellent company in a different industry.

Investors are bombarded with information designed to lead them off course and toward more conventional means that involve excessive trading, higher costs, and frequent detours based on the latest prognostication from talking heads or so-called gurus.

The simple message to let capitalism be your guru quickly becomes stale and completely lost among the attention-grabbing headlines of the day. A constant reminder that the media is in the entertainment industry and their objective is not to give sound advice but to attract an audience may help tune out the noise.

Tuning out the noise is even harder when it is amplified by an investment industry thriving on complexity and confusion, while frequently shunning simple yet effective solutions. After all, the most lucrative products to sell are often the ones in which investors don't really know what they are getting or how much it costs.

9) BEHAVING BADLY

Investors ought to periodically review their plan and stick to it if the approach is still the right one. But adhering to a prudent investment strategy often becomes elusive in a world of continually streaming news and complex investment products. These forces can overwhelm human emotion and lead many investors astray.

A vast amount of research into how the human brain is wired documents tendencies known as behavioral biases. These biases make even highly intelligent investors particularly susceptible to the conventional approach of Wall Street and the messages purveyed by the media. An entire field of study known as behavioral finance, a mix of economics and psychology, has discovered biases that influence investment decisions. They have technical names like overconfidence, mental accounting, regret avoidance, extrapolation, and self attribution bias. What do they all mean? In a nutshell, investors may not be rational, but they are normal—meaning they're often their own worst enemy.

10) SIMPLE BUT NOT EASY

A prudent investment approach following these fundamentals is like a steady diet of healthy food—simple, effective, boring, and difficult to maintain. It is well documented that good food, exercise, avoiding too much alcohol, and sufficient sleep will improve the odds of being healthier. It is also well documented that accepting that markets work, avoiding stock picking and market timing, effectively diversifying a portfolio, and paying attention to costs will improve the odds of being wealthier. It sounds simple, but it isn't easy. ■

The helpful comments of Eduardo Repetto are gratefully acknowledged.

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