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The Tao of Investing

It is almost embarrassingly easy. Nothing could be simpler.

It is preposterously hard. Few activities are as challenging.

Most students of the financial markets know the road to success, yet few manage to travel it. Knowledge and action are different commodities. Many pay lip service to rational, diversified, periodically-rebalanced portfolios, but few can resist doing something else. There is always something more winsome – technology stocks in the late 1990’s, Japanese stocks in the late 1980’s and “alternative investments” and hedge funds now. For the portfolio of an aging parent or the charitable foundation, the investor may insist on the diversified portfolio. But not for himself – after all, he knows what he’s doing. By shunning what they know to be generally right, investors often wind up getting it precisely wrong.

Investors often shun the generally right, only to be precisely wrong.

Investing is not the only endeavor with this paradox. Everyone knows the way to lose weight is moderate exercise and eating a sensible, low-fat diet. Yet many of us are still overweight. People find it very difficult to follow the simple, effective but boring method, preferring to try an exotic new diet or, like Jared, eat too many Subway sandwiches. A trip to the bookstore suggests we feel we need 400 books on how to lose weight. Weight loss gurus achieve fame and fortune, without any aggregate poundage really being shed, when everyone knows the real answer for free.

Or consider three doctors encountering patients with the same disease. The first does not discover the illness until it is life threatening, but then demonstrates his skill by saving the patient in an invasive, dangerous, emergency surgery. His fame spreads far and wide. The second doctor acts when the patient is quite sick, if not at death’s door, and prescribes appropriate medicine. She is well thought of, but not as highly regarded as the first doctor. The third realizes the danger before the patient is sick and prevents the illness through relatively minor steps. People do not think of him as an accomplished healer.

Let’s say a manager’s record matched the returns on the Nasdaq Composite Index until October 2002. Now imagine that from the Nasdaq low in October, her accounts gain 100 percent over the next three years. With that trailing three-year performance, she will be on the cover of financial magazines, heralded as a genius, with investors throwing money at her to work her magic. Even after that gain, however, a client account starting in March 2000 would have declined 57 percent. Lauded as a hero based on the recent returns, the manager has butchered the wealth of her long-standing clients. A diversified manager with a less volatile

record has done a much better job for his clients, but a more staid course does not excite the imagination of investors, magazine editors or anchors of financial programs on TV.

Enclosed is our 2002 annual listing of the performance of the four major asset classes: large stocks, small stocks, foreign stocks and bonds. The best performer each year has a box around it. On the right are two mixes of the assets, representing aggressive and balanced diversified portfolios. The data shown are from indexes, so there is no assumed impact from timing or security selection. We show 37 years, starting when we have the first performance data for foreign stocks.

Investing in the “balanced mix” (with 60 percent in stocks and 40 percent in bonds) has had an average annual total return almost identical to a portfolio 100 percent invested in the S&P 500 index, while experiencing substantially less risk. The average annual total return from being invested only in *government bonds* is within two percent of the return from being invested only in the S&P 500. This narrow gap is significant when compounded, but nowhere near the chasm most people would have thought after years of “stocks for the long run” indoctrination.

***In investing, greater effort
and complexity often
leads to lower returns.***

Imprinted by the stellar performance of U.S. large company stocks in the late 1990’s, few investors would guess that large stocks have been the best of the four

asset classes in only five out of 37 years. Bonds and international stocks were each best in eleven years and small U.S. stocks were best in ten years. By this measure, large U.S. stocks are the worst of the four and have “won” only half as many times as the next worst.

The loss of almost 38 percent in large stocks during 2000-02 was the worst three year decline since 1930-32, when the U.S. slid into the Great Depression. The balanced mix portfolio, however, lost only about 13 percent in the last three years – not as good as advancing, but far better than a huge majority of investors. If you have matched the recent record of the balanced mix portfolio, congratulate yourself – you are in the upper echelon of investor performance. Despite the obvious, if plodding, success of the diversified, balanced portfolio, a gaming instinct leads most investors away from it to the latest product generated in the canyons of Wall Street. Most investors have done far worse than any of the numbers shown on the chart, always leaping to the asset with good past performance but poor future performance.

Some dieters hire personal trainers to embarrass them into exercising and, in some cases, to rifle through cupboards to root out caches of junk food. Providing similar help for our clients, we enforce the simple discipline of diversification and rebalancing in a thoughtful, calm manner. If you would like this help, contact us. We’ll let you keep the Fritos.