THE INVESTOR'S MANIFESTO

PREPARING FOR PROSPERITY, ARMAGEDDON, AND EVERYTHING IN BETWEEN

WILLIAM J. BERNSTEIN

FOREWORD BY JONATHAN CLEMENTS

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To Kate, Johanna, and Max:
May they find this useful.

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Foreword

Bill Bernstein—investment advisor, neurologist, economic historian, bestselling author, thinking person's financial guru—is perhaps the smartest man I know. And, fortunately, he is also one of the most approachable. Indeed, during my 13 years as the *Wall Street Journal's* personal-finance columnist, he was the source I invariably turned to when the well ran dry.

"So, Bill, what's on your mind these days?" I would croon down the telephone, hoping a certain jocularity would mask my desperation as yet another column deadline loomed. Bill, thank goodness, almost always delivered. Because he had turned his considerable intelligence to the financial world relatively late in life, he had enthusiasm and insights that eluded the rest of us, who had grown jaded from watching the Wall Street money-go-round for too long.

You will discover that enthusiasm and those insights in *The Investor's Manifesto*, delivered in plain English and with a touch of hyperbole and a helping of humor. Bill and I do not agree on everything, but there is one thing we are both convinced of: The recent economic and market debacle is a great "teachable moment," to steal Bill's phrase from the preface, and it may represent the best investment opportunity in a generation.

So what should you learn from the 2008–2009 financial collapse? You will get Bill's take in the pages that follow. To get you warmed up, here I highlight five important—but perhaps less obvious—lessons.

1. Many of us are not as brave as we thought.

To earn high returns, we need to take high risks. The stock market sure seems risky in 2009, which is a reason for optimism. But even if stocks deliver healthy gains over the next few years, we may not reap the reward if we make panicky decisions in the face of market turmoil.

Have you got what it takes to be a successful stock-market investor? This may be the best chance you will ever get to assess your stomach for risk. If you calmly rode out the 2008–2009 decline, maybe you can indeed live with a stock-heavy portfolio. But if you were terrified by both the economic turmoil and your own investment losses, perhaps you should move toward a more conservative investment mix in the years ahead.

2. Leverage can sting.

Many of us engage in mental accounting, associating the auto loan with the car, the mortgage with the house, and the credit-card balance with the wild weekend in Cancun. Yet, once we have incurred these debts, they effectively leverage our entire finances. This simple truth has lately been hammered home, as the past decade's borrowing binge ran smack into the brutal decline in stock and home prices.

Let's say you went into 2008 with a $400,000 house, a $200,000 stock portfolio, and $300,000 in debts. Your stock portfolio's value might have tumbled to $100,000 and your home might have dropped to $350,000, for a stinging 25 percent decline in your combined assets. But what really stung was the hit to your net worth, which is your total assets minus your total liabilities. That would have fallen a staggering 50 percent.

3. Our homes likely will not pay for our retirement.

The recent collapse in the housing market should have finally killed off the popular notion that "you can't go wrong with real estate." Even if folks are no longer banking on double-digit annual housing gains, they often still view their homes as part of their retirement nest eggs.

To be sure, upon quitting the work force, we could unlock some of our home equity by trading down to a smaller place or taking out a reverse mortgage. But buying and selling real estate is not cheap, and reverse mortgages come loaded with fees. Moreover, we have to live somewhere—which means our homes are best viewed as a consumption item, not as an investment.

4. We need to save. Duh.

If we cannot bank on double-digit annual housing gains—or, for that matter, double-digit stock-market gains—what should we do? That's an easy one: We probably ought to be saving like crazy.

Indeed, with any luck, the recent economic turmoil will nix some of the silly justifications for America's pitifully low savings rate. In the 1990s, financial experts told us we did not need to save because our stock portfolios had grown so fat. In the current decade, experts assured us we did not need to save because our homes were worth so much.

Since then, of course, our stock portfolios and our homes have plummeted in value. It turns out the fabulous stock returns of the 1990s, and the glorious real-estate results of earlier this decade, were effectively borrowing from the future—and that future arrived with stomach-churning ferocity. The lesson: Do not use great investment returns as an excuse to cut back your savings rate, because great returns may be followed by wretched ones.

5. Perhaps the smart money is not so smart.

The earlier part of this decade was a time of great financial envy, as we watched the "smart money" buy into hedge funds, private equity, and other investments that were beyond the reach of ordinary investors. We imagined that they were getting mouth-watering returns, while we were left to invest in mundane mutual funds. Glorious returns? Alas, it did not turn out that way for those who invested with Bernie Madoff and his ilk.

But that is enough from me. It is time to listen to Bill. The odds are, you will be wiser for his words—and maybe wealthier, too.

Jonathan Clements
Author, *The Little Book of Main Street Money*
July 2009

Preface

I wrote my last investment book almost eight years ago, and I swore I would never write another. That was for two reasons.

The first was that finance is a relatively circumscribed field; not that much is really known for certain. The body of knowledge that the individual investor, or even the professional, needs to master is pitifully small. If most finance academics were asked to compile a body of truly essential scholarly articles, their lists would generally not be more than several dozen long. On the other hand, put the average doctor, social worker, or scientist to that task, and the required reading would fill many shelves, if not whole rooms. In short, I had said most of what I needed to say about finance in my first two books. Until now.

The financial meltdown of 2008–2009 drastically changed the investment landscape, and if there ever was a time to leapfrog my previous books, it is now. This is a teachable moment, and I intend to use it to clearly and concisely enunciate a set of timeless investment principles.

In 1934, the father of the science of modern value investing, Benjamin Graham, wrote a great brick of a book, *Security Analysis,* which spelled out today's commonly accepted techniques for evaluating stocks and bonds, and it remains to this day required reading for anyone seriously interested in finance. As with any comprehensive, variegated work, it strikes individual readers in different ways.

Graham's graceful prose and methodical composition bowled me over, a shining exemplar for any financial writer. He illuminated a devastated investment terrain of the battered stocks and bonds of the nation's once-mighty corporations strewn about and nearly available for the taking—in short, an environment not unlike today's.

Graham, almost alone among his generation of investors, ran the numbers and concluded that anyone with cash to spare was crazy *not* to own at least some stocks. He recommended a 50/50 stock/bond split; today, most would consider this allocation conservative, but in 1934 it struck most as certifiably reckless.

When I first read *Security Analysis* decades ago, Graham's descriptions of those chaotic long-ago markets reminded me of a B-movie about the Fall of Rome: faintly interesting, but hardly relevant to the placid and modern financial scene.

I was wrong—dead wrong. The markets are placid no longer, and at some points in 2008 and 2009 the resemblance of valuations to those of 1934 were closer than most of us would have liked; in the not-too-distant future, they may yet be again. As in the depths of the Great Depression, there are now generous returns to be had for the brave, the disciplined, and the liquid. If there was ever a time to own a prudent portfolio that includes equities for the long term, it is now.

My second reason for not wanting to consider another finance book had more to do with ideology than financial economics. Successful investing requires a skill set that very few people possess. This is difficult for me to admit; after all, I have written two books premised on the idea than anyone, given the proper tools, can turn the trick.

Once again, I was wrong. Having emailed and spoken to thousands of investors over the years, I have come to the sad conclusion that only a tiny minority will ever succeed in managing their money even tolerably well.

Successful investors need four abilities. First, they must possess an interest in the process. It is no different from carpentry, gardening, or parenting. If money management is not enjoyable, then a lousy job inevitably results, and, unfortunately, most people enjoy finance about as much as they do root canal work.

Second, investors need more than a bit of math horsepower, far beyond simple arithmetic and algebra, or even the ability to manipulate a spreadsheet. Mastering the basics of investment theory requires an understanding of the laws of probability and a working knowledge of statistics. Sadly, as one financial columnist explained to me more than a decade ago, fractions are a stretch for 90 percent of the population.

Third, investors need a firm grasp of financial history, from the South Sea Bubble to the Great Depression. Alas, as we shall soon see, this is something that even professionals have real trouble with.

Even if investors possess all three of these abilities, it will all be for naught if they do not have a fourth one: the emotional discipline to execute their planned strategy faithfully, come hell, high water, or the apparent end of capitalism as we know it. "Stay the course": It sounds so easy when uttered at high tide. Unfortunately, when the water recedes, it is not.

I expect no more than 10 percent of the population passes muster on each of the above counts. This suggests that as few as one person in ten thousand (10 percent to the fourth power) has the full skill set. Perhaps I am being overly pessimistic. After all, these four abilities may not be entirely independent: if someone is smart enough, it is also more likely he or she will be interested in finance and be driven to delve into financial history.

But even the most optimistic assumptions—increase the odds at any of the four steps to 30 percent and link them—suggests that no more than a few percent of the population is qualified to manage their own money. And even with the requisite skill set, more than a little moxie is involved. This last requirement—the ability to deploy what legendary investor Charley Ellis calls "the emotional game"—is completely independent of the other three; Wall Street is littered with the bones of those who knew just what to do, but could not bring themselves to do it.

As recently as a generation or two ago, lack of financial ability did not greatly handicap the average person. Most Americans did not have much money to invest, and the employees of large firms often participated in a traditional corporate defined-benefit (DB) pension plan, which was professionally managed and strove to provide them and their survivors with a reliable stream of retirement income.

The traditional DB plan, unfortunately, has gone the way of disco as Americans have had to become their own investment managers, herded like cattle into so-called defined-contribution (DC) plans—401(k)s, 403(b)s, and, worst of all, 457s. Somehow, the powers that be have decided that average workers should manage their own investments.

This makes about as much sense as expecting the average person to be his or her own airline pilot or family surgeon. Preposterous? Perhaps with flying complex aircraft or removing a son or daughter's appendix, but when it comes to managing retirement portfolios, most Americans find themselves in precisely this situation.

In fact, any reasonably intelligent person can solo a simple aircraft after a dozen hours of instruction, and surgeons occasionally joke that they could teach an above-average chimpanzee to perform an uncomplicated appendectomy. (The hard part is not knowing how, but rather, when to operate, and how to manage the patient before and after the surgery.) Yet, as the recent financial maelstrom demonstrates, competently and safely managing money often eludes even those at the pinnacle of the financial profession.

As a result, this book is fraught with a great deal of cognitive dissonance. I love investing and derive no small pleasure writing about it for others. Certainly, in a world where everyone has become his or her own investment manager, whether he or she likes it or not, helping small investors to manage their nest eggs would seem to be a laudable goal. It is just that it is not, in many cases, a realistic one.

That said, given current market conditions, I could not resist taking yet another stab at writing an easily comprehensible finance book. Certainly, I did not succeed with my first, *The Intelligent Asset Allocator.* I was gratified with the response to it, both among academics and general readers. Sadly, I was less than pleased by what my friends and family told me, which usually went something like this: "Jeez, Bill, it seems you know what you're talking about, but I fell sound asleep by the second chapter." So I wrote my second book, *The Four Pillars of Investing*, which I aimed, or so I thought, at the average liberal arts graduate. This time, I got fewer complaints, but there was still plenty of grousing about the unnecessary complexity of my tables, graphs, and examples.

This time around, I have attempted a book that I hope will be accessible to almost everyone, particularly the tens of millions who have found themselves unwillingly thrust into the role of portfolio manager. Rather than completely eliminate some of the more abstruse points, I have segregated them into optional boxed "Math Details," sections for more mathematically inclined readers that, while not essential, refine the appreciation of the investing process.

The Roadmap

This book's first three chapters explore the theoretical basis of investing and designing portfolios and are liberally laced with a fair amount of financial history. I have done this for two reasons. First, the theory can get pretty complex. Human beings deal with complexity by spinning narratives around it; this not only makes the difficult concepts more understandable, but also more entertaining as well. (Albert Einstein most famously resorted to piquant narrative to explain his theory of relativity by imagining the relative motion experienced by riders on two trains on parallel tracks. He did this not only to amuse and educate others, but also, at least initially, to help himself think about the process.)

Second, and more importantly, no matter how well an investor masters the theory of investing, he or she is lost if he or she lacks the ability to coolly observe extraordinary current events and say "I've seen this movie before, and I know how it ends." A small example will suffice: In 1994, former Salomon Brothers executive John Meriwether assembled the most brilliant group of financial experts ever seen, including Nobelists Myron Scholes and Robert Merton, into a firm called Long-Term Capital Management. Not only did his partners understand the mathematics behind their options-related strategies as well as anyone on Wall Street, but they were in many cases the inventors of these techniques.

For a few years, their strategies worked like a charm and generated annual returns of over 40 percent. There was just one problem: The data they based their strategies on covered only a relatively brief period of time. It never occurred to them to consider the longer span of data or the broad narrative sweep of financial history. Had they done so, they would have realized that about once every decade the wheels come completely off the machinery of the markets, and the old relationships among various kinds of investments, which they profited so mightily from, temporarily reverse with a vengeance.

In 1997 the world economy, along with Long-Term Capital Management, ran into a speed bump when Asia suffered from a debt crisis similar to the recent meltdown. The next year this spread to Russia, which defaulted on some of its debt. Around the world, the prices of nearly all financial assets, save those of the government bonds of developed nations, plummeted in unison—something that had not occurred during the brief period of market history that the Long-Term Capital partners had based their strategy on—and forced the company's liquidation under the anxious eyes of the Federal Reserve. Meriwether and his brilliant associates had made the classic mistake of getting their math right and their history wrong.

The present investment landscape is in many ways as extraordinary as any seen in finance, but its outlines are still easily understandable by those with a good grasp of the calumnies that have savaged investors in previous centuries. For example, anyone familiar with the collapse of Long-Term Capital Management would not have been taken completely by surprise by the recent meltdown. The point is not to predict when such calamities can occur—that is impossible—but simply to know that they *will* occur from time to time, and that you should design your long-term investment strategy appropriately.

If the financial disasters described in Chapters 1 and 2 do not convince you of the need to diversify your risks, then nothing will. In Chapter 3, I explore the ways in which ordinary investors can construct portfolios that should at least blunt some of the damage that can be rained down by the fickle goddess of finance.

Just as I employ a financial telescope to survey broad swaths of investment history and theory in the first three chapters, in the fourth a microscope turns inward to understand the greatest enemy facing investors: the visage in the mirror staring back at them.

The reason why most people do such lousy jobs with their portfolios is that human nature is an agar dish that breeds all manner of investing psychopathology. Two of the most virulent behavioral organisms are overconfidence and an overemphasis on recent history.

In 1998, a classic article by *Wall Street Journal* reporter Greg Ip dissected both these foibles. The Gallup organization polled investors in both June and September of that year—just before and just after the aforementioned Russian bond default and the Long-Term Capital Management debacle—on what they thought their own portfolio returns, and that of the overall market, would be.[1] Here were the results:

Expected Returns	June 1998	September 1998
Next year, own portfolio	15.2%	12.9%
Next year, overall U.S. market	13.4%	10.5%

Three things leap out from this table. First, note how optimistic the estimated returns are. These numbers are more than a bit higher than the long-term returns for stocks in the United States, the nation with the best results among all major markets.

Next, on average the individuals polled expected that they would beat the market by about 2 percent (the difference between the numbers in the first and second rows). This is remarkable, since, in the aggregate, these investors *are* the market. Further, average investors do not receive even the market return, but rather that return reduced by the expenses they pay. Within a few decades, these slow leaks will deflate any portfolio.

Finally, and most remarkably, their return estimates *fell* after that summer's price decline. Now, there is no greater truism in investing than this: The less you pay for an asset, the more money you are likely to make when you eventually sell it. A fall in price, under most circumstances, should lead to a higher expected return. Yet, the Gallup data quoted by Mr. Ip showed just the opposite: The average investor expects a higher return when buying at high prices than when buying at low ones.

Not only were American investors ludicrously overconfident, but their outlook was irrationally influenced by recent returns. Their estimates were grossly inflated by the high returns of the 1990s tech bubble, in which anyone who could fog a mirror could earn, at least for a little while, 20 percent per year.

Unfortunately, the long-term data on market returns showed 10 percent to be normal. Worse, the most commonly accepted methods for estimating future market returns suggested yet lower returns. Worst of all, investors' estimates moved in the *same* direction as stock prices, which is the opposite of what simple logic suggests.

Chapters 5 and 6 focus on dealing with the investment industry to execute the investment strategies devised in the previous chapters. Once you have mastered investment theory, investment history, and your own emotions, this is by far the easiest task.

I emphasize three main principles: first, to not be too greedy; second, to diversify as widely as possible; and third, to always be wary of the investment industry. People do not seek employment in investment banks, brokerage houses, and mutual fund companies with the same motivations as those who choose to work in fire departments or elementary schools. Whether investors know it or not, they are engaged in an ongoing zero-sum, life-and-death struggle with piranhas, and if rigorous precautions are not taken, the financial services industry will strip investors of their wealth faster than they can say "Bernie Madoff."

Consider this book a lifeboat manual. Tens of millions of Americans, and hundreds of millions abroad, have been tossed onto a turbulent investment sea. The waters are more