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Follow instincts, but trust history

By Stephen J. Butler

Basking in the sun with a beer and a hot dog, I reveled in a dramatic come-from-behind victory at an Oakland A's game that prompted me to think about their successful practice of "Moneyball." This is the concept spelled out by Michael Lewis in a book of the same title that describes the A's use of statistics to make cost-effective decisions about what players to hire and when to use them effectively.

Legendary baseball manger Tony LaRussa, by comparison, employs more intuition while drawing on years of personal experience and then acting on what we would call instincts or "hunches." Today, baseball seems to be splitting into two camps with winning teams in contention representing both schools of thought. If baseball exhibits this struggle, what similarity could exist in the world of the investing public?

Hunches and instinct are the hallmark of the baseball scouting profession, and these folks are betting on their ability to make sound decisions based largely on subjective feelings about young players. All players at the minor-league level of the sport have good statistics, so the trick is to make a decision as to which ones to hire today that might someday excel in what they describe as "the big show" — the major leagues.

When picking investment managers, or allocating assets between different types of investment classes, intuition is probably not as productive as a careful review of historical results over long time periods. Winston Churchill's mother made a fortune timing the bubble of South Seas investment companies correctly in what he later describes as "repellently good timing." Such cases are few and far between. George Soros, who made billions betting against the British pound, recently closed his firm after suffering large losses.

The latest craze of widely publicized hedge fund managers are supposed to be investment gurus, but, as a group, they have averaged only a paltry 7 percent per year over the past several years. A few early successes at timing one investment move or another can be detrimental if it leaves us with a sense of omnipotence.

The book "Blink" offers yet another argument for trusting our instincts by pointing out examples of when groups of people make a collective, split-second guess that, on average, turns out to be correct. This is deceptive because we need to distinguish between, say, investing money and meeting someone for the first time. Instincts applied to the latter can definitely be valuable as in the Will Rogers reminder that "one never gets a second chance to make a first impression." Because we see similar encouragement to rely on instincts in many areas, there is a temptation to apply the same methodology to investing. This is generally a big mistake.

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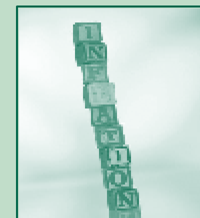

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Fed inflation tune hits

INVESTORS HARD

By Stephen J. Butler

The most endearing recent article about Alan Greenspan was about his early career as a saxophone player in a touring swing band. He gave it up because he realized he would never be as good as a fellow band member, who happened to be future jazz great Stan Getz.

Years later, Greenspan had better luck as a protégé of Paul Volcker, who he then succeeded as chairman of the Federal Reserve Bank.

Volcker struggled with the aftermath of the Arab oil embargo of the mid-1970s, a five-fold price shock which contributed to double-digit inflation rates, sometimes as much as over 18 percent.

But by the mid-1980s, the price of oil was in a downward spiral that eventually caused a recession in Saudi Arabia of all places.

Oil-based economists would argue that Greenspan had an easy time of it and his only challenge had been to appear to be doing something.

The 18-year reign of our departing Fed leader has everyone convinced that his ham-fisted grip on the money supply was the key to our economic success throughout his watch.

I'm not convinced.

For those of us investing for retirement, I think it is dangerous to assume that a few smart people at the helm of a government money press can exert much control over the "invisible hand of economic forces." We should not expect the government to somehow make everything turn out OK.

Greenspan coined the term "irrational exuberance" to describe the stock market run-up that he couldn't fathom based on what he understood his own contribution to be. He describes the current inverted yield curve (short-term rates as high as long-term rates) to be "a conundrum." Back in October 2001, he said, "Anyone who has a great conviction at this stage about what the economy is doing or what proper policy is, I think, is under a mild state of delusion."

Now, we have the new guy, Ben Bernanke, who firmly believes that 2 percent inflation is just about right.

Since the Vietnam war, the theory has been that a little inflation is a good thing.

A lot of inflation is a wonderful thing for a government saddled with a huge amount of debt — those debts eventually get paid off with inflation-cheapened dollars. Ronald Reagan lowered taxes but tripled the nation's debt with the expectation that a period of hyper-inflation would reduce the cost of the debt.

It worked. People on fixed incomes suffered, but at least their Social Security benefits were inflation-indexed and kept pace with the increased costs of food and shelter.

The second most likely candidate to be the Fed chairman was Martin Feldstein, who is a firm believer in no inflation and as little federal debt as possible. It should be obvious why he didn't get the nod.

We need to be concerned about inflation for two reasons:

First, interest rates rise with inflation and interest rates constitute the single most powerful influence on corporate profits. Corporations having to pay more to borrow money will experience lower stock prices.

Second, inflation dramatically increases the prices of what we will be hoping to spend money on downstream in retirement. While stock prices might not plunge, we can't expect them to rise at their historic 10 percent per year.

Coupled with this disappointment is the fact that the costs of what we hope to enjoy in retirement will be steadily rising — perhaps entirely out of our reach. When it comes to investing, there is no right answer we can determine until after the fact. But an educated guess never hurts, and it looks like this might be the time to consider short-term bond funds or even one-year bank CDs for some of our money.

For the latter, paying about 4.5 percent, consider visiting bankrate.com, which ranks CDs issued by banks across the country. Forget money market funds, especially those offered by the major brokerage firms that pay just a fraction of 1 percent.

This is not to suggest any exodus from the stock market. It is only to point out

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In an early Gary Larson cartoon, the student at Jack's Jackhammer School has his ample beer belly draped over the handle of the machine. The instructor is saying, "That's it. Let the fat do the work."

Markets, not firms, are money makers

By Stephen J. Butler

That image came to mind as I read David F. Swensen's new book, "Unconventional Success — A Fundamental Approach to Personal Investment."

Swensen is the 20-year manager of Yale University's endowment fund, a fund that compounded at an average of 16 percent per year during his tenure. He started when he was 31 years old, when Yale had $1.3 billion and shepherded that mass of cash to more than $16 billion today. Along the way, annual payouts to Yale for its operating expenses have been as much as $550 million.

The book started out to be an exercise in sharing investment techniques that the "little guy" (people like you and me) could use in order to be just as successful as Yale. However, the more time Swensen spent in the myriad opportunities available to average Americans, the more he realized how much the deck is stacked in favor of financial institutions.

The book that began as an instructional tome morphed into a polemic against the abuses perpetrated by the financial world. Even our regulatory agencies fail to escape Swensen's wrath.

To the extent that he does share his investment strategy, it boils down to the following three simple concepts:

1) work with high-quality mutual fund families (i.e., nonprofit or non-publicly owned) whose funds' interests are aligned with investing customers;

2) diversify investments across different core asset classes, and

3) rebalance periodically by selling portions of the winners and buying more of the losers.

The high-quality mutual fund issue points out that any publicly-held fund family has a powerful incentive to make money for its stockholders. In case after case cited by Swensen, these funds have made decisions and perpetrated abuses that benefited themselves over what could have been a better outcome for investors.

The purest alternatives are fund families, like TIAA-CREF started by the Carnegie Foundation to provide retirement investment opportunities for college professors. Vanguard, run as a giant nonprofit cooperative, falls into the same category. Next down the scale is the group of privately held smaller fund families (I would choose Dodge & Cox as one of the better examples).

These are fund families run by owners who, by now, have made more money than they could possibly ever spend and who are soldiering on for the benefit of their reputations and the judgment of history. These fund families are quick to close successful funds to new investors when spectacular results trigger a flood of new money.

At the bottom of the list are the funds sponsored by major brokerage firms generally designed to provide trading profits and commissions.

The wisdom of diversifying investments is illustrated with compelling statistics, charts and graphs. If that were not enough, the book is full of anecdotal evidence and great examples of the degree to which results of different investment types are "inversely correlated." When one type of investment is doing well, another will be in the dumps.

Swensen has strong feelings about bonds and the need to include them in portfolios for their balancing effect, but he is insistent on only using U.S. government treasury bonds. He sees corporate bonds as being hopelessly stacked against the interests of small investors. Their pricing is not transparent and they can often be "called" — paid off and terminated — when it serves the interests of the borrower.

The third component of success is the practice of rebalancing. The greatest hurdle to periodically selling a bit of our winners and adding money to our losers is psychological: We basically just hate to sell a winner. We love our winners.

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Follow instincts... *(from page 1)*

The difference between investing money and meeting someone for the first time is that information on investment history is voluminous. There is more information than anyone would ever want to know about the characteristics and success of different investments during varying economic cycles. You don't have to judge a book by its cover. You can read the whole book.

In the simplest example, the comparison of the stock market versus home value increases would tell us that our houses have been by far the best investment. However, if we factor out the cost of improvements, maintenance and inflation, the long-term rate of return on housing has historically been only about 3 percent. The stock market, by comparison, has been earning 7 percent over the rate of inflation.

Meanwhile, an NBC News/Wall Street Journal poll indicated that 80 percent of Americans think that real estate is a safer investment than the stock market. Remember that a 20 percent drop in housing values can wipe out all of your equity for a 100 percent loss. A 20 percent drop in the stock market only causes a 20 percent loss.

When it comes to investing, we can have these hunches about what might lead to success, but numbers rarely lie and they tend to repeat. Appreciating this tendency could protect us from our worst instincts and lead us to a winning season. ■

Fed inflation... *(from page 2)*

that as one of many asset classes to consider for portions of a retirement portfolio, short-term debt is looking more favorable today than it has in the past five years. If inflation is on the rise and here to stay, this advantage will only widen.

To see what that might feel like, ask any of today's older retirees how much they enjoyed collecting 18 percent annual interest on no-risk money market funds back in the early 1980s.

Imagine that. A financial world equivalent to a Getz jazz classic. ■

Markets, not... *(from page 3)*

Unfortunately, the winners we love don't know that we own them, and sooner or later, those winners will become losers relative to our other asset classes. Swensen blasts Morningstar in this respect as he points out how the world's premier mutual fund ranking service misleads people by implying that past performance will be repeated into the future. Their star rating continues to be based, at least in part, on a "proprietary" formula that we will never fully know.

Does any of this sound familiar? As I read the book, I felt like Swensen had been reading my mail. Last month marked the sixth year I've been writing this column, and much of my material over the years has centered on the themes espoused in this new book. It's a system that is simple — and it works.

Like the fat hanging over the jackhammer, we can let the markets do the work. Just don't let the financial services industry get in the way. ■

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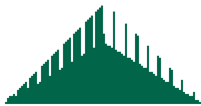

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