

WIN

Investing in the the stock market might seem like a foolish gamble these days. But if you play your cards right, you can develop a winning strategy and build a solid portfolio.

THE LOSERS GAME

by
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Like many of you, I get increasingly frustrated trying to figure out the stock market. Surely with the power of computers and the wealth of information on the Internet, an intelligent person should be able to invest successfully. There is no dearth of magazines, newsletters, TV programs or gurus ready to help. Shucks, how hard could it be to just buy the top ten funds recommended by *Money* or *Forbes*? If you want someone else to do it for you, there are over 10,000 professional money managers running mutual funds and private accounts.

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But as I looked over the historic data, some questions kept popping up. For instance, why did lists like “Mutual Funds for a Lifetime” change every year? If they were suitable for a “lifetime” in, say, 2000, why were they dropped from the list only a year later? Why did lists of “hot” fund managers on various “All Star Teams” seem to change all the time? Did they get stupid all of a sudden? Hmm ...

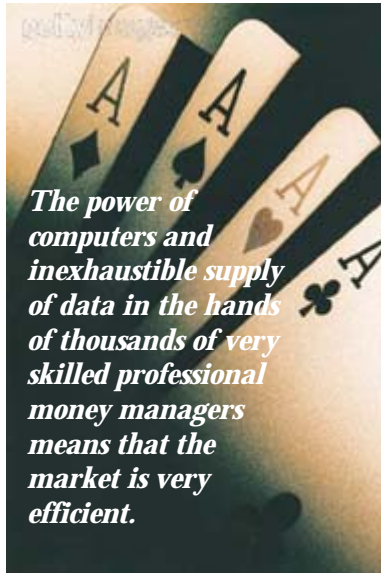
Perhaps we could just follow the top mutual funds that Morningstar accords their top “five-star” rating. Those folks track more data than we can comprehend. Surely they have got it right. But a study in the September, 2000 issue of the *Journal of Financial Planning* showed that about half of the top funds lose their four- or five-star rating within a year. Not very useful if you are investing for a lifetime! (In fact, a *Hulbert Financial Digest* study covering 1993 to 2000 showed that the average total pretax return for the top funds was less than 50 percent of the total market’s return!!)

The wrong question

Someone once said there is no right answer to a wrong question. All the lists and ratings and stars are based on the past. Interesting as they are, they have *no* predictive value. We all give lip service to the obligatory fine print that says, “The past is no indicator of future performance” — but we all secretly hope that there must be some trend that will continue. If Tiger Woods has a proven track record in golf, then one logically assumes that will continue. Ditto with Michael Jordan in his prime.

The problem is there is *no* single Tiger Woods or Michael Jordan of investing. More accurately, there are *too many* Tigers and Michaels! The power of computers and inexhaustible supply of data in the hands of thousands of very skilled professional money managers means that the market is very efficient. So it is almost impossible for any one manager to consistently get a useful edge over the other. If the buyer thinks they got a “steal” when they bought a stock or fund for \$50, the seller is equally glad to have snookered someone to take it off their hands for \$50!

Think how you would place a bet on a football game between your state college team and your local high school team. It doesn’t take a genius to bet on the college team. But what if you could add 50 points to the high school team’s score? 75 points? 100 points? This



“spread” would be applied to induce folks to bet on the high school team. That spread is constantly changing as the best minds (bookies and bettors) try to establish equilibrium. That’s what the pros and the market are doing when the price of a stock is determined. To beat the market, you have to find a stock that you think has been “mis-priced” by a lot of very smart people!

Zero sum game?

One of the \$50 traders above is obviously wrong — we just don’t know which one. We might say it is a “zero sum” game — that there is a loser for every winner. But it is actually worse than that. Every time you play, there are trading costs, whether you are the winner or the loser. Playing too often can get expensive. (By the way, since professional “institutions” do 80 percent plus of all market trades, how do you hope to play competitively in that game?)

So, a successful investor either needs to have access to information that no one else has (does a certain TV homemaking guru and illegal insider trading come to mind?), or they have to interpret the same information better. Do you really think that you (and the million viewers who watched the latest CNBC analysis) are the only people who suddenly realized that the population is aging, the internet is getting faster, ocean front land is disappearing, etc.? And you are going to build a can’t-lose portfolio around those “secret” trends?

Some folks appear to have a hot hand for awhile, but if you dust off the old financial magazines, you find that their results are actually random— in fact, not even as reliable as a series of coin tosses. (I actually do the coin toss demonstration in my seminars. Even when we see it, human nature still won’t let us believe the results.) It is the random, unknown information that proves whether the buyer or seller was right over time.

Consider the following exercise: We want to place bets on which newly hatched turtles will make it safely to the sea. As you know, these turtles will lay a billion eggs, but only a tiny fraction of the hatchlings will make it past the snakes, sea gulls, and other perils to the sea. Do you think that sheer brainpower, examination of individual newborns, tide table analysis, or anything else will allow one of the players to consistently pick the winners? Smart players will try to determine whether size, speed, etc. might influence the odds of success, but there is just too much unknown data. (Which gull will

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swoop down when?, etc.)

In fact, the conventional wisdom may fool you. Seagulls are attracted to motion, so a larger, faster newborn is actually a better target and a statistically poorer bet. A malformed, small, sluggish newborn may actually have a better chance. But then, a slow snake may more easily pick it off. Decisions, decisions ... (One observer did notice that more of the newborns made it to the sea on the days a certain sunbather wore a green bathing suit instead of a blue suit. He was last seen organizing a technical timing newsletter to sell to the other players.)

Ask the Wall Street Journal

As professionals, we are used to the idea that if you are smart, work harder than the next person, get up early, etc., you should be successful and move to the top of the class. Frustrated that this paradigm does not seem to work with investing, I wrote to Jonathan Clements, the Wall Street Journal columnist. I literally asked him, “Why don’t brains count?” He reinforced my conclusions and compared investing to tennis, contrasting professional players with the rest of us. At the professional level, they are so good that they can occasionally force a winning shot. But at our amateur level, we get in trouble by trying to make heroic shots we aren’t capable of. Over time, we find that the winners are the ones *who make the fewest mistakes!*

He suggested several popular books that further explain his philosophy. Two of them are *The Only Guide To a Winning Investment Strategy You’ll Ever Need* by Larry Swedroe, and *Winning the Loser’s Game* by Charles Ellis. They are both easy to read.

The way Jonathan Clements and the two authors would play the turtle game would be to place a small bet on *every* turtle rather than go for broke on just a few. Although it’s a pretty boring game that way — and it seems downright un-American not to try to pick the winners — history shows that this broad approach to stocks can beat the vast majority of stock pickers over time. In addition, it would save a lot on costs because a passive player would not keep switching his bets.

Of course, part of what this particular philosophy means is not putting all of your, uh, turtle eggs in one basket. This seems to make sense and goes by the popular term “asset allocation.” But that isn’t the whole story. Asset allocation is a logical method to diversify one’s investments. If one investment goes bad, at least



they won’t all go bad at the same time.

Maybe. The problem is that simply owning more than one stock or mutual fund is not necessarily diversifying. Consider the case of a woman who has all of her money invested in Exxon stock. Is she really diversifying if she sells half her stock and invests in Shell Oil? What happens if oil prices go down? Both stocks get clobbered. True diversification means having money invested in unrelated companies. So she would be smarter to have half her money in Exxon and the other half in, say, Southwest Airlines. If oil prices drop, that is bad for Exxon but good for

Southwest. If oil prices go up, that is presumably good for Exxon but bad for Southwest. Diversification is not quite this simple. For example, both of those companies share the fact that they are still based on the overall U.S. economy and attitudes about the stock market. Perhaps further diversification would include real estate, international stocks, or even bonds. A word of caution: many people think they are diversified by holding a number of mutual funds, but you have to consider what stocks those funds own. Many popular, big-name funds own many of the same big-name stocks, so you probably aren’t as diversified as you think.

It’s the costs, Stupid!

Unless you think like Will Rogers, you probably intuitively agree that asset allocation makes sense. (Rogers once said, “Don’t gamble. Take all your money and buy one good stock. When it goes up, sell it. If it don’t go up, don’t buy it!”) If you do decide to diversify, which stocks will you buy? Whether it’s mutual funds or a basket of individual stocks, the level of activity managing those investments highlights the second proposition of Clements and the other authors: due to trading costs, combined with the historic fact that few professional managers consistently outperform the stock market averages, one should invest passively rather than actively. (In their March 15, 1999 issue, *Fortune* reported that just 4 percent of all equity funds outperformed the S&P 500 Index over the prior 15 years, and that this low figure was even less than one would have expected from random statistical variation.)

Costs can be a big factor since the typical, actively managed mutual fund has an annual turnover rate of about 90 percent and expenses of about 1.8 percent, according to Ellis. This means that the fund will have bought and sold the equivalent of almost the entire con-

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tents of the fund every year. Some funds have turnover rates up to 400 percent! Who do you think pays for all that trading, bid/ask spreads, etc.? It's especially frustrating if you pay for a lot of trading when the Fortune article above shows that such trading rarely enhances returns.

One popular passive approach is to simply buy something like the Vanguard 500 Index Fund. That satisfies the "cost" part of the equation (it has low turnover, which allows for low operating expenses), but it does not really satisfy the "diversification" issue. You may be investing in the 500 largest companies in the U.S. (the S&P 500) — or are you? An S&P Index fund is not an equal mix of the 500 stocks. It is "weighted" such that the companies with the largest market value (number of shares of stock times the value per share) have a disproportionately large representation. In fact, just the 50 largest companies (like GE, Microsoft, etc.) account for about 60 percent of the entire S&P 500 Index!

So you are really investing primarily in the largest of the large companies. In addition, it turns out that these are typically high-priced "growth" stocks. As comforting as those big, familiar company names sound, they represent only one type of asset class known as "large growth." There are other asset classes, such as small growth and small value; however, no particular asset class consistently outperforms the rest. So, in the name of diversification, you should have some of your portfolio in funds that fall in other asset classes too. Again, low-cost international funds, real estate, and bonds would further enhance your diversification.

Strategy vs. outcome

We seldom find people with investment problems as much as we find "investments with people problems." Statistically we know that a low-cost, diversified, passive, boring program will outperform most active managers over time. However, it is emotionally difficult for an investor to stick with a winning strategy when they encounter bumps in the short term. The tendency is to chase the latest hot thing. It's the "country club syndrome." You were happy making, say, 10 percent until you heard that one of your buddies made 20 percent. You may have a good, long-term strategy, but it didn't work as planned in the short run. Does that mean the strategy was wrong?

Presume that you are the coach of the Washington Wizards and that Michael Jordan is still at the top of his game. You are behind by one point with 10 seconds to go. You have time for one shot to win the game. Who gets the ball — your best player, Jordan, or someone else? The most reliable strategy is to go with Jordan. Sure enough, he gets the ball — but misses the shot and you lose! Did that mean your strategy was bad? What if

you had the same decision to make the next night? Isn't the statistically smart play to give it to Jordan again? In fact, if you gave it to somebody *other* than Jordan and that player missed the shot, you might get fired! Don't change a winning strategy just because you don't get the desired outcome every time.

Your next step is to develop that winning strategy.

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