THE SMARTEST PORTFOLIO YOU'LL EVER OWN

A Do-It-Yourself Breakthrough Strategy

Daniel R. Solin

A PERIGEE BOOK

Also by Daniel R. Solin

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To Patricia, for whom kindness and compassion are a way of life.

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INTRODUCTION

A Lesson from Einstein

Everything should be made as simple as possible, but not simpler.
—Albert Einstein

We can learn a lot about investing from Albert Einstein. As legend has it, when he died, he met two men and a woman outside the pearly gates. Always one to strike up a conversation, he asked them about their IQs.

The woman said her IQ was 190. Einstein was excited. He said, “We can discuss my theory of relativity.”

The first man said his IQ was 150. “Good,” said Einstein. “We can discuss global warming and arms reduction.”

The second man sheepishly said, “I’m sorry, but my IQ is only 100. I’m afraid I won’t have anything to discuss with you.”

Unfazed, Einstein looked at him intently and said, “That’s not a problem at all. Where do you think the market is headed?”

Here’s the real skinny on investing:

- It’s not complicated.
- No one has a clue where the markets are headed—not even Albert Einstein!
- Holding individual stocks or bonds exposes you to higher risk without higher expected return.
- Holding any actively managed mutual fund increases your costs and reduces your expected return.
- Using the services of brokers or advisers who claim to be able to beat the markets significantly reduces your chances of capturing market returns.
- The free market system works. Stock prices are random and efficient. There is no mispricing.
- There’s a wealth of irrefutable data supporting these views.

The idea that index based investing is simple and vastly superior to stock picking, market timing, and efforts to pick the next “hot” mutual fund manager shakes the very foundation of the securities industry. If investing were so simple, why would you need their services? Why should you purchase their actively managed mutual funds and annuities? Why should you listen to their stock picking and market timing recommendations?

The value of do-it-yourself investing in index funds was the basic message of my previous book, *The Smartest Investment Book You’ll Ever Read*. If you followed the recommendations in that book, you emerged from the market crash of 2008 largely unscathed because you were in a portfolio appropriate for your risk tolerance. When the markets tanked, your paper losses were tolerable. You did not panic. You held on, and benefited from the rapid recovery in 2009–2011.

~~The success of *The Smartest Investment Book* spawned tens of thousands of savvy investors.~~ They wanted to know if there was any way to improve the returns of the index fund portfolios I recommended.

The answer is yes. These portfolios are well known to a small group of advisers who understand th data and have access to the funds (available only through them) necessary to construct a portfolio tha could achieve this goal. Until now, if you were an investor who wanted to go it alone, you did not hav access to the funds, or the knowledge, to truly maximize your returns. Now you will.

A note of caution and full disclosure: I am an adviser. I recommend passively managed, risk-adjuste portfolios to my clients, following the principles used to construct the SuperSmart Portfolio set forth in this book. I believe most investors are well served by retaining an adviser who understands and implements the sound, academic underpinnings of these portfolios.

But I have to be realistic. I know many of you will continue to use brokers or advisers who claim t be able to beat the markets by picking stocks or recommending hot mutual fund managers. What you will learn in this book will give you the ammunition you need to protect yourself from these "investment professionals."

I also know many of you may not have a portfolio large enough to interest advisers who follow the sound investing principles I describe in this book. Or you may simply want to do it yourself and save the advisory fees, even when confronted with facts showing that paying the fee is in your best interes when you consider total returns.

For whatever reason, I believe you should be empowered to have the most optimal portfolio available. I wrote this book so you can do just that. The rest is up to you.

If you come across a word or phrase you don't understand, please refer to the Glossary. You will most likely find it there.

Finally, most investors will benefit from a discussion of what they are currently doing wrong and a review of the academic underpinnings for the Smartest Portfolios. For those who just can't wait to se the allocations and funds in the SuperSmart Portfolio, you will find this information in Chapter 21. Comparable information for the three alternative Smartest Portfolios can be found in Chapters 23 through 25.

PART ONE

The Wrong Way

If you are like 90% of investors, you're investing the wrong way. You abandon common sense and basic principles of due diligence when it comes to managing your money. An entire industry makes a living fostering bad investor behavior. Their conduct enriches them. It's depriving you of superior market returns, which are easily attainable.

Before you can invest the right way, you need to understand what you are doing wrong.

CHAPTER 1

A Battle for Your Brain

Shaped a little like a loaf of French country bread, our brain is a crowded chemistry lab, bustling with nonstop neural conversations.
—Diane Ackerman, *The Alchemy of Mind*

I am going to tell you exactly how to invest your hard-earned money to maximize your returns and minimize risk. I will not just spout abstract theory. I will give you the tools to determine which portfolio is right for you. I will tell you exactly which funds you should invest in. You can implement my recommendations in a couple of hours, at most.

My recommendations don't reflect just my opinion. They are the product of the finest minds in finance today, backed by reams of academic studies. Most people who don't agree with them are not familiar with the data or have a vested interest in leading you down the wrong financial path (like "market-beating" brokers and advisers).

Is there a catch or a hidden agenda? Is this too good to be true?

Absolutely not.

For those who want to go it alone, I give you the tools to do so. Just set up an account with an online broker, place the trades for the group of funds you have selected from the options I provide to you, and you are on the way to a demonstrably superior way to invest. The online brokerage firm will profit, but their costs per trade are very low. Many offer to place trades for $7 or less.

The funds I recommend do charge management fees, but their expenses (known as *expense ratios*) are as low as 0.07% per year. I don't benefit. I have no interest in the brokerage firms or in any of the recommended funds.

So, what's the rub?

Your brain.

Studies of neuroeconomics, an interdisciplinary field that seeks to explain human decision making show that emotions drive investment decisions as much (or more) than objective data.

Powerful emotions, most notably greed and fear, are very dangerous because most of us are not aware of their potent influence as they activate chemical secretions in the brain. The possibility of a "big score" in the markets actually releases dopamine in the brain. Brain images of investors as they watch a stock that is rapidly increasing in value are remarkably similar to scans of those addicted to drugs or alcohol.

According to Jason Zweig, author of *Your Money and Your Brain*, it's the dopamine rush that explains "why we play lotto, invest in IPOs [initial public offerings of stocks], keep too much money in too few stocks and invest with active portfolio managers instead of index funds."

Other behavior factors also influence our investment decisions and keep us from adopting simple strategies that would benefit us financially.

A well-known basis for misperceptions called the *halo effect* was first documented in 1920 by E. L Thorndike. The halo effect refers to the tendency to form an overall opinion about a person or circumstance based on a perception in one area. If, for example, we find one trait we like about a person, we carry that positive evaluation over to other traits. In one study, subjects were shown one o two videos with the same talk by the same lecturer. In one video the lecturer was in “nice guy” mode In another, he was “nasty.” Those who viewed the nice guy video thought of the lecturer as more attractive than those who viewed the nasty video.

The Madoff Ponzi scheme is the poster child for how the halo effect can affect investors. The perception of “Bernie” (which sounds almost cuddly) was that he was highly reputable, a pillar of integrity, and totally trustworthy. These perceptions of his personality and his background (including stint as chairman of NASDAQ) caused investors to slide down a slippery slope. They assumed the investments in his fund were as reputable as he appeared to be and failed to do basic due diligence, ignoring obvious red flags. There was a subconscious carryover of what they believed were positive personal traits to an investment that they should have evaluated independently.

Another study showed that mutual funds that changed their names to take advantage of current hot investment styles significantly increased inflows of assets, despite no increase in performance.

The ramifications of neuroeconomics are profound.

First, understand that your brain may be pushing you toward the thrill of short-term decisions, whe your real focus should be on long-term ones.

Second, stockbrokers understand the power of neuroeconomics much better than you do. They use the halo effect and other emotions (primarily greed and fear) to drive you to take action that is good for them and bad for you.

Remember what happened during the 2008 market crash? The financial media went into overdrive positing all kinds of scenarios of financial Armageddon. Investors were encouraged by their brokers t flee to safety. Many followed this flawed advice, selling stocks and buying bonds, gold, and money market funds. This was great for brokerage firms. Commission income surged.

How did listening to this advice work out for you? If you had done nothing, you would have recovered all (or most) of your losses when the markets surged back from 2009 to 2011.

This is really a battle over your brain. I want your brain to dispassionately assess the data and information I am giving you. Your stock-broker wants to trigger a chemical reaction in your brain th will cause you to abandon common sense and act emotionally.

What’s the Point?

Understanding how your brain can interfere with making intelligent investment decisions can lead you to make smarter decisions that will help you reach your financial goals.

CHAPTER 2

In Bizarro World, These Traits Would Be Valued

Yeah. Like Bizarro Superman. Superman's exact opposite, who lives in the backwards bizarro world. Up is down, down is up. He says "hello" when he leaves, "good-bye" when he arrives.
—Jerry Seinfeld

Almost everything about the behavior of investors is mystifying.

You work so hard for your money. You are meticulous, diligent, and cautious. No one is goin to take advantage of you or your company on your watch!

You carefully reference-check the backgrounds of new employees. You even pay for an extensive criminal search and verify college transcripts. You do the same with vendors. Lack of honesty or integrity, even on a small scale, is a deal breaker.

How do you apply these traits when it comes to investing those hard-earned dollars? Many of you continue to use brokers employed by brokerage firms with a long history of acting against the best interest of their clients.

In 1990, we had the junk bond scandal, culminating in a guilty plea by junk bond king Michael Milken to multiple felony charges and an agreement to pay penalties of $600 million. Milken ran the high-yield bond department at Drexel Burnham Lambert. Other prominent traders caught up in the scandal included Ivan Boesky, who pleaded guilty to securities fraud as a part of a larger insider trading investigation.

In April 2003, 10 of the largest brokerage firms agreed to pay $1.4 billion to settle charges their research had misled investors. The allegation was that the firms basically sold out their retail clients (that's you!) to curry favor with the companies for whom they did lucrative underwriting business.

Some of the internal documents obtained by the Securities and Exchange Commission (SEC) were chilling. In one famous email, Jack Grubman, who had obtained near-deity status as the telecommunications analyst for the firm known at that time as Salomon Smith Barney, called a company he was recommending to retail clients of the firm a "pig." Emails from other analysts referred to highly touted companies in even more unflattering terms.

The settling firms were a who's-who of the securities industry and included Credit Suisse, Merrill Lynch, Lehman Brothers, Morgan Stanley, J.P. Morgan, and Goldman Sachs.

In April 2004, Janus Capital Group agreed to pay $100 million in fines to resolve charges it allowe favored clients to engage in excessive trading in its mutual funds that hurt other investors. Putnam Investments and Bank of America had previously agreed to settlements involving similar conduct.

In March 2006, the SEC announced a settlement with Bear Stearns involving allegations it engage in "late trading" and "deceptive market timing." Bear Stearns agreed to a penalty of $250 million.

~~In 2007, Bank of America agreed to pay $26 million to settle allegations its traders used~~ information generated by its analysts to trade stock before the information was disseminated to the public. You would think the April 2003 $1.4 billion settlement of the analyst scandal involving simil practices would have had a long-lasting effect. Not so. According to the SEC, the analysts also issued false research, touting companies in an effort to secure their underwriting business. Sound familiar?

There were a litany of other enforcement actions against other members of the securities industry, but I'm sure you get the point. (For a timeline of various proceedings against members of the securities industry, check out http://timelinesdb.com/listevents.php?subjid=575&title=SEC.)

All this pales in comparison to the conduct that contributed to the 2008 market crash. This debacle in which toxic subprime mortgages were sold to clueless buyers with low credit ratings, almost precipitated a global depression. Who were the main players in this mess? The biggest ones were Bar of America/Merrill Lynch, UBS, J.P. Morgan Chase, Citigroup, Morgan Stanley, Wells Fargo, Royal Bank of Scotland, Credit Suisse, Goldman Sachs, and Barclays.

Some of the revelations about the inner workings of these firms as this crisis unfolded are revealin and disgusting. According to one report, "The 'Subsidy'" by Jake Bernstein and Jesse Eisinger (*ProPublica*), several years before the crisis gathered full steam, traders at Merrill Lynch refused to buy the supposedly safe portions of the mortgage-backed securities Merrill was creating. The traders obviously knew what the public was about to learn: These securities were toxic.

Merrill is reported to have solved this problem by forming a new group to take on the money-losin securities. By paying millions of dollars of bonuses to the traders in this group, the money machine continued for Merrill, until the house of cards collapsed, causing losses of hundreds of billions of dollars to clueless individual investors.

Senator Carl Levin, the chairman of the Permanent Subcommittee of Investigations, issued a scathing 640-page report on the conduct of Goldman Sachs. The report found that Goldman Sachs profited from the decline in mortgage-related securities at the same time as it was peddling these "investments" to its clients. The fallout from this chicanery was immense. Merrill Lynch was sold to Bank of America. The venerable Lehman Brothers filed for bankruptcy. American International Grou suffered massive losses and needed a $40 billion lifeline from the Federal Reserve to stay in busines The cash infusion subsequently shot up to $150 billion.

Bear Stearns was sold for peanuts to J.P. Morgan Chase, in a deal backed by the taxpayers—you ar me. Goldman Sachs and Morgan Stanley Smith Barney converted to commercial banks.

The crisis was exacerbated by blatant conflicts of interest at the credit-rating agencies, whose ratings misled buyers into believing that snake oil (risky subprime mortgages) was really vitamin water (AAA-rated bonds). The SEC subsequently approved measures to strengthen oversight of credi rating agencies. In the understatement of the century, the SEC announced findings of "serious deficiencies" with the process. Those of us who live in the real world do not need a study to help us understand the existence of a conflict of interest when the people doing the credit rating at the credit-rating agencies are paid by the issuers of the securities being rated.

The scandals involving big Wall Street players continue unabated and undeterred. On December 7, 2010, Bank of America agreed to pay $137 million to settle charges it defrauded buyers of municipal bond derivatives.

It's not just the extent of the fraudulent conduct of the securities industry that's so striking. It's th fact that it involves the largest and best-known players.

The conclusion is inescapable. This is an industry infected by systemic greed and the absence of ar ethical or moral code of conduct. They want your money. They will do or say anything to get it. They view the fines they pay as simply a cost of doing business.

All this, standing alone, is reason enough for you to refuse to do business with them. Unfortunately there's more. The entire premise of the way they manage your money is fatally flawed, rife with conflict of interest, and designed to transfer your money to them.

You don't live in bizarro world. Walk into your broker's office and say good-bye. He or she will understand it doesn't mean "hello."

What's the Point?

These dogs have had more than their one free bite.
Don't give them another.

CHAPTER 3

Investing Without Eddie O’Neal

The nature of any human being, certainly anyone on Wall Street, is “the better deal you give the customer, the worse deal it is for you.”
—Bernie Madoff

Losing money is always bad. Losing it to a crook is even worse.

In 2006, I was the cofounder and a principal in an investment advisory firm. My partner in this venture was Eddie O’Neal, then an assistant professor of finance at the Babcock Graduate School of Management at Wake Forest University. At the time, hedge funds were all the rage and we were unde pressure from our clients to generate the kind of outsized returns these funds were reporting.

In the latter part of 2006, Eddie and I traveled to New York to meet with a senior executive of the Fairfield Sentry Fund. The executive explained that his firm had almost $20 billion in assets under management, of which approximately $6 billion were invested with an advisory firm run by Bernie Madoff. He reviewed Madoff’s stellar returns with us. They were impressive—a remarkably consistent 1% a month, regardless of market conditions, with very few exceptions.

Our man from Fairfield thought there was a possibility he could use the leverage of his firm to get our clients in on the action—if we invested through Fairfield—even though (according to him) the current demand exceeded Madoff’s ability to manage more money.

Eddie, who’s as smart as he is self-effacing, sat quietly throughout the meeting. Just as we were about to leave, he asked one question: “How do you monitor Madoff’s performance?” It was obvious a question the Fairfield executive had answered many times before. In a mildly condescending tone, he told us they had “the most sophisticated monitoring possible” located on-site at Madoff’s offices. He stated that “when a keystroke is placed by a Madoff trader, it records at our offices.” The marvels of technology! I was impressed.

As we left and got into a cab, I turned to Eddie and asked him what he thought. He looked at me an said, “I don’t believe the returns.” I asked him what due diligence he would have to do to alleviate hi concerns. He said, “None, because these returns are not possible.” That was it. We never pursued discussions with Fairfield or with any other hedge fund.

Many others were suspicious of Madoff’s operations long before December 2008, when he confessed to running a massive Ponzi scheme. Spanish banking Goliath Banco Santander invested $3 billion of its clients’ assets with Madoff. According to an internal report, its staff knew that his operations were “shrouded in secrecy” and lacked independent verification.

You didn’t need Eddie’s historical perspective on market returns to question Madoff’s operations. would not have been difficult for anyone to spot the biggest red flags. He had no independent custodian for the assets of his clients. His accounting firm was not exactly one of the Big Four. The three-person firm that certified Madoff’s books had previously advised the American Institute of

Certified Public Accountants that it didn't conduct audits! The firm had only one active accountant, and he operated from a small office in a strip mall.

So how did the most sophisticated feeder funds get duped by this primitive scheme? The list includes not only the Fairfield Greenwich Group but other investment giants like Banco Santander, Tremont Group Holdings, Kingate, Mount Capital, and Access International Advisors Europe, whose cofounder committed suicide after Madoff's scheme was exposed.

Why? Just follow the money and the answer is obvious: fees. By some accounts, total fees generated by feeder funds from clients who invested with Madoff amounted to an unbelievable $790 million over the years! Fairfield Sentry is reported to have earned more than $500 million in fees since 2003 from funds it invested with Madoff.

These firms had the ability to detect this primitive fraud. They turned a blind eye to it and sold out their clients for the obscene fees they were earning by simply endorsing their clients' checks over to Madoff.

You don't need Eddie O'Neal to assist you with your investment decisions. But you should know better than to deal with people who have consistently sacrificed your well-being to fatten their own (already bulging) wallets.

What's the Point?

The securities industry is a wolf in sheep's clothing.

CHAPTER 4

Join a Wise Crowd

What distinguishes index funds is that they don't presume to have greater wisdom than the collective market, but instead try to channel its wisdom to your advantage.
—Zack O'Malley Greenburg, financial journalist

I am frequently invited to talk to investment clubs. I have a standard response: You don't want me because I will tell you either to disband your group or to call it a social club because that's what it i

More often than not, they persist. They want to *prove* to me that I am wrong. They believe they can demonstrate how they can beat the markets.

Members of investment clubs believe they benefit from the collective wisdom of the group. We have common ground on this issue. We both believe there is something to be learned from the wisdo of crowds, but diverge sharply on the conclusions to be drawn from it.

It's well documented that the collective wisdom of very large groups of people results in decisions that are often superior to those made by any individual member of the group.

In his excellent book *The Wisdom of Crowds: Why the Many Are Smarter Than the Few and How Collective Wisdom Shapes Business, Economies, Societies and Nations*, James Surowiecki gives man examples of collective wisdom. Here's one: The average guesses by a crowd at a country fair of the weight of an ox were more accurate than most of the individual estimates. That average was also closer to the actual weight than the estimates of cattle experts.

Surowiecki notes that not all crowds are wise, particularly those characterized by homogeneity and those subject to emotional factors (like peer pressure) and imitation (where initial decisions by group leaders are copied by others). A wise crowd is one that features a broad diversity of opinion and independence, among other traits.

Investment clubs have the traits of an unwise crowd. They typically lack diversity and have a tendency to be influenced by opinions of other members of the club. Their collective judgment about stock prices is likely to be "unwise" and certainly not as valuable as the views of the totality of the investment community outside their group.

The data on investment club performance support this view. One exhaustive study by Brad M. Barber and Terrance Odean showed that 60% of clubs underperformed the market. The average club underperformed a broad market index by 3% a year. Viewed through the lens of the wisdom of crowds, this makes perfect sense.

Club members fight tenaciously to justify their validity. I recently addressed a club consisting of a group of wealthy individuals at a gated community in Naples, Florida. They told me the past returns the Vanguard Wellington Fund (VWELX) "proved" they could beat the market and challenged me to persuade them otherwise. They picked an excellent fund to underpin their argument. The Wellington Fund is a balanced fund, with a low expense ratio (the operating costs of the fund) of 0.34%. Its annualized return for the 10 years ending September 30, 2000, was 14.12%. For the ensuing 10-year period, its return was 5.58%. These returns exceeded the median returns for all balanced funds by 0.71% in the first 10 years and by 3.18% in the second. They put this question to me: Given the stella performance of this fund, why did I believe it was unlikely their group could not beat the market?

I looked at the performance of all 60 balanced funds for which data were available for both 10-yea periods. Here's what I found: When funds outperformed in one period, they rarely were able to repea that outperformance in the following period. The data demonstrated a statistically meaningless correlation between stellar performance in one period and similar performance in the next 10-year period.

If skill was a meaningful factor in outperformance, the correlation would be much higher. Think o it this way. In most areas of demonstrable expertise, you would see a persistency of the skill. It's unlikely that Roger Federer will slip from his high ranking one year to competing in the qualifying rounds the next. The conclusion is inescapable that outperformance of these funds (or of any one of them) was a random, unpredictable event, unrelated to the skill of the fund manager.

Investment clubs serve many useful functions, like networking and socializing. If you are a memb of one, you should understand the very nature of the activity of the group (attempting to pick mispriced stocks or find the next hot fund manager) will likely result in lower returns. You would be far better off relying on the wisdom of wise crowds.

The millions of investors all over the world looking at stock prices meet the definition of *wise crowds*. It's highly likely that their views of a fair price for a given security are accurate. Don't fight them. Join them.

What's the Point?

The judgment of all investors worldwide is wise. You should heed it.

CHAPTER 5

Trading Against Goldman Sachs

By the way, all of the jokes here tonight are brought to you by our friends at Goldman Sachs. So you don't have to worry, they make money whether you laugh or not.
—President Barack Obama

By this time, I hope I have convinced you there is something fundamentally wrong with the abysmal lack of ethics on Wall Street. The culture of greed has caused them to betray your interests, time and again. I have also shown why you may be subconsciously drawn like bees to honey to the entreaties of brokers who promise big rewards with scant regard to risk.

Now I want to get to the heart of the matter: Buying and selling is the lifeblood of the securities industry. They want you to buy and sell stocks, bonds, mutual funds, options, gold, and all the other financial instruments their fertile minds can dream up.

Here's the first question I want you to ask yourself before you engage in any of these transactions: Who's on the other side of the trade?

Remember this: If you are buying, someone else is selling. If you believe a stock is going up, someone else believes it is going down. When you place a trade, you are making the assumption that you know more than the person (or firm) on the other side of the trade. How confident are you of that conjecture?

Trading has become a huge portion of the profits of the brokerage and investment banking firms through whom many people are placing trades. In the first nine months of 2010, trading fees accounted for 36% of Morgan Stanley's revenues and a much higher proportion of its profits. Big Wall Street firms have major trading advantages their customers lack. They have huge resources, including both personnel and computer technology.

Whatever they are doing seems to be working. Goldman Sachs reported net earnings of $8.3 *billion* for 2010. Its net revenue in investing and lending activities was $7.54 billion.

Since you have no way of knowing whether the person on the other side of your trade is Goldman Sachs or Joe Shmoe, why are you so confident in your judgment that your trade is a good one? If you are trading because you think you are going to make a big score, keep in mind that big returns mean you are assuming big risks. Risk is a two-way street.

Trading is a very bad idea. Unlike Goldman Sachs, you won't make money no matter what happens. It's more likely you will have tears in your eyes.

What's the Point?

Don’t underestimate the intelligence of those on the other side of your trade.

CHAPTER 6

What You Can *Really* Learn from Dr. Doom

I am not going to say I told you so, but I did.
—Nouriel Roubini, professor of economics, New York University, Stern School of Business

You are really tough. The moral turpitude of Wall Street doesn't faze you. The prospect of trading against people with far more resources and expertise doesn't scare you. You don't believe the market sets fair prices. You think you (and your broker) know more than the collective wisdom of the markets. This chapter is for you.

Your trading strategy assumes you and your broker have some predictive power, either concerning the market in general or a particular security you are about to trade. You must have this core belief since, as I have explained, today's prices reflect all current information. It's tomorrow's news that moves stock prices. There are a lot of gurus who say they know tomorrow's news. They make all kind of predictions.

Probably the best-known market seer is Nouriel Roubini, professor of economics at New York University's Stern School of Business. He is also the chairman of Roubini Global Economics, an economic consultancy firm.

Roubini bolted into prominence by accurately predicting the crash of the housing market, which he said would "sink the economy." This prediction instantly gave him the newfound status of seer. He was courted by the financial media, and his negative predictions about the market and the economy earned him the nickname "Dr. Doom."

Flush with confidence, Roubini gave very specific advice to investors contemplating investing in the market in 2009. Here was his advice:

> For the next 12 months I would stay away from risky assets. I would stay away from the stock market. I would stay away from commodities. I would stay away from credit, both high-yield and high-grade. I would stay in cash or cash like instruments such as short-term or longer-term government bonds. It's better to stay in things with low returns rather than to lose 50% of your wealth. You should preserve capital. It'll be hard and challenging enough. I wish I could be more cheerful, but I was right a year ago, and I think I'll be right this year too.

The Dow Jones Industrial Average gained 22.68% in 2009. The S&P 500 gained 23.45%. The NASDAQ was up 43.89%. Professor Roubini was right about 2008. He was dead wrong about 2009. That's my point.

Roubini is not alone in making bad predictions. Here's one from the National Association of

Realtors’ former chief economist David Lereah, in November 2005. You would think you could rely on ~~his views concerning the future of the housing markets: “The good news is that inventory levels~~ a improving and housing supply will come closer to buyer demand in 2006. We expect a healthy and more balanced market next year.” The housing market started its downward spiral in the summer of 2006.

Who knows more about the state of the economy than Federal Reserve Chairman Ben Bernanke? I March 2007, here’s what he had to say about the subprime crisis: “At this juncture, however, the impact on the broader economy and financial markets of the problems in the subprime market seems likely to be contained. In particular, mortgages to prime borrowers and fixed-rate mortgages to all classes of borrowers continue to perform well, with low rates of delinquency.”

After the market crash and the housing crash in 2008, Bernanke was asked to explain his faulty prediction. He dryly stated, “Of course, I would like to revise and extend my remarks.”

If you need further evidence of the folly of relying on self-styled seers, consider the analysis of market timing newsletters by Jeffrey M. Laderman in *Business Week* that showed that none of them beat market returns for the 10-year period studied. These newsletters were sold to the public by peop claiming to have special, valuable insights into the future. They didn’t.

Rich Dad Poor Dad author Robert Kiyosaki made this prediction about the stock market for 2010: “The current stock market rally will probably turn into a dead cat bounce. If the Dow drops below 6,500, 5,000 may be the next stop.” The Dow ended 2010 at 11,577. The market looked more like a raging bull than a dead cat.

Sometimes the experts are right. Sometimes they are wrong. Don’t mistake luck for skill. You can call it *skill* when you are right and *bad luck* when you are wrong. There is no data indicating anyone has predictive powers about the future—much less the future of the markets.

Here’s something else about predictions you may not know: They are more likely to be correct simply as a matter of luck than you might expect. If you make 10 forecasts, and each one has a 10% probability of correctly predicting the future, there is a 65% chance that at least one of your forecasts will be correct.

When your investment strategy relies on predictions—no matter how credible the source—you are gambling, not investing.

What’s the Point?

Predictions have zero reliability. Smart Investors ignore them.

CHAPTER 7

The Myth of the Lost Decade

I've lost a bet. I've lost my keys. But I've never lost a decade —until now.
—Sam Stovall, chief investment strategist at S&P Equity Research Services

The securities industry has a lot of weapons in its arsenal to keep you in its fold. One of the most potent (and misleading) is its reference to the "lost decade." The argument goes like this: The S&P 500 index was basically flat for the past decade. Investors who followed an indexing-based approach suffered as a consequence. The concept of "buy and hold" is also dead.

What's the alternative? You are told to trust your broker, who can help you through these troubled times by anticipating market corrections, investing in stocks when the market is going up, and sellin them before it goes down.

The financial media, which derives significant advertising revenue from the securities industry, poured kerosene on the lost-decade fire. The *Wall Street Journal* noted that "Adjusted for inflation and dividends, the return on the S&P 500 was negative for the decade that ended on June 30 [2008]." And *Business Week* joined the fray, calling it a "decade of decay."

I had a front-row seat to the intensity of this issue when I appeared on CNBC's *Power Lunch* on April 17, 2009. I was asked for my views about the best way to save for retirement. I said, "One of th things that you could do . . . is to give us more 'In Bogle we Trust' and much less 'In Cramer we Trust.'" (I was referring to John Bogle, the founder of Vanguard Group, and a strong proponent of index-based investing; Jim Cramer is the hyperkinetic host of the CNBC show aptly titled *Mad Money*.)

At that point in the interview, Cramer stormed onto the set and proceeded to trash index funds. Here's what he said:

> In all due respect, the S&P is flat literally for ten years . . . That's John Bogle's world . . . I've had it with the people who tell me about the index fund . . . For ten years they've done nothing! For ten years! When do they get called on the carpet? When are they ever wrong? Do we have to wait another ten years? Enough of this! I've said my piece.

He then stomped off the set.

This is errant nonsense, but it does provide an opportunity to expose how Wall Street misleads you Initially, the S&P 500 index is *not* an appropriate benchmark for the U.S. stock market. The best inde for that purpose is the Wilshire 5000, which measures the performance of *all* U.S. stocks (although th performance of this broader index was also flat for the same decade).

The S&P 500 index does not include any international stocks, which should be part of any properl