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Facing the Future with Optimism and Courage
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Desert Musings

My wife and I are enjoying the warm Phoenix weather. So, it's time for my annual desert musings.

The more financially literate Americans become, the better it is for all of us. But there's already more information available to investors than anyone can absorb. Unfortunately, most of it is either too academic for most people to understand, sales literature masquerading as information or useless forecasts. Making even more information available won't increase financial literacy. It will create confusion which will lead to investment decisions based more on emotion than fact. You don't need to be a genius to be a successful investor. You need to understand a few basic investing truths and have the ability to control the urges that get most investors into trouble.

Investors give credence to forecasts because they confuse events that are uncertain with those that are unknowable. The result of a roll of the dice is uncertain but has a limited number of possible outcomes. The result of a war is unknowable because the number of potential outcomes is almost unlimited. You should ignore all economic and market forecasts, not because they deal with uncertain events but because they deal with unknowable events.

Perhaps the biggest fraud perpetuated by financial advisors – one that has cost investors more money than all the Ponzi schemes in history - occurs when clients ask "What's the stock market going to do?" The only honest response is “I don’t know.” But few advisors have the integrity or self-confidence to give this answer (trust me on this, I know these people). They’d rather assume an air of certainty and be wrong than admit that they don't know. The financial and emotional costs of this ongoing, inexcusable deceit are paid for by their clients.

Many do-it-yourself investors act under the assumption that what has happened in the stock market in the recent past will continue - a behavioral error known as recency bias. It's a convenient substitute for thought and careful analysis. It inevitably leads to performance chasing that produces concentrated, non-diversified portfolios.

Their fondness for the "good old days" indicates to me that too many baby boomers are suffering from failing memories.

Baby boomers have spent the last 40 years passing their financial illiteracy down to their children. Today, their children believe that the key to achieving their long-term financial goals is finding the right software. Unfortunately, financial success has more to do with behavior than programming code.

You can’t manage your long-term investments with a short-term focus. Creating a retirement portfolio is like planting a tree – leave it alone for a long time, water and fertilize it regularly and someday you'll be napping in its shade.

The greatest financial risk for new retirees is not portfolio volatility. It's owning a portfolio that's so "safe" that it won't generate growth that outpaces inflation over a multi-decade retirement. Too many conservative retirees fall into the "safety trap" because they mistake dollars for purchasing power.

Successful investing isn't an easy task and you don't make it any easier by buying complex, illiquid investments that you don't understand from people more interested in the size of the commission than the suitability of the recommendation.

Markets have become more volatile over the past 20 years and the financial media shares part of the blame. The financial media has too many microphones and too few worthwhile things to say. It must make investing (a very boring subject) entertaining and nothing is more entertaining than being scared out of your wits. Since the end of the financial crisis, it has provided a parade of doomsters spouting a litany of reasons why the stock market is about to experience a colossal collapse. Some media commentators attempt to educate viewers. Others, the self-serving ones, attempt to deceive them. Unfortunately, it’s almost impossible to tell one from another. I recommend that you ignore the daily financial news. Not because it’s wrong – but because it’s irrelevant to long-term investors.

If you scour the financial news every day, you're not normal. Normal people have more important things to do than engage in this time-wasting activity. There is no “edge” to be gained by tuning in. Since everyone has access to all the facts, no one has an information advantage – which is no different than having no information at all. For financial journalism to prosper, it needs to convince you that the information you need to be a successful investor changes daily. Viewers and readers who fall for this ruse become portfolio tinkering, short term speculators - to their ultimate regret.

In my experience, there is no improvement in mood or mental state after watching the news. What's in the news isn't close to a representative sample of what's happening in the world. All reporting is superficial – limited by the time constraints of TV and radio. Ignore the news for a month and spend the extra time reading books. You won't miss anything important, you'll be better informed and less stressed.

Your broker would rather have you sneeze in his face than sell you an index fund. What’s worse, it’s likely that your broker doesn’t understand the academic or historical evidence that makes passive investing a superior strategy.

Each day, more than 90% of the 60 million trades in the global stock markets are made by professionals – fund managers, retirement plan managers, endowment managers and the like. Stock prices represent the consensus opinion of these skilled, profit-seeking investors. Stop and consider this the next time you hear some pundit insist that the market is undervalued or overvalued. There's little or no chance that he's correct and that everyone else is mispricing stocks. The core assumption of all such assertions is that stock prices are inherently random; not the result of extensive research and analysis. The prices that result from all this trading aren't perfect but they're certainly not irrational.

As long as it operates on a suitability standard (recommending investments that are "suitable" for clients) instead of a fiduciary standard (recommending investments that are in a client's best interest), Wall Street will gladly sell you whatever your little heart desires – even if it’s the rope you’ll use to hang yourself.

Both debt and drugs can ruin your life. Yet while many drugs are illegal, some debts are tax-deductible. Go figure.

Every year, there are outperforming mutual funds that gain media attention. But no investor knows if the market beating returns were the result of luck or skill. What’s worse, the managers of these funds don’t know either. But it’s a safe bet that they’ll credit their success to skill and accept any and all kudos for being so astute.

The newly minted stockbroker knows almost nothing about the stock market, life, asset allocation strategies, diversification, history or the needs, thoughts and values of affluent clients. Yet throughout the USA these people are offering newly retired baby boomers investment advice about how to make sure that their assets fund a multi-decade retirement. Am I the only person who thinks that this won't end well?

Past performance is not for sale. We all know this. Every financial advisor says it to his clients. Then why are so many of them trying to make a living by selling it?

The default investment option in most 401(k)s is a target date retirement fund. These funds are supposed to offer the best "glide path" (changing portfolio allocation) as you get closer to your expected retirement year. But all glide paths are based on assumptions about unpredictable asset class returns and correlations. The more asset classes used in a fund, the more unpredictable the long-term outcome of a glide path becomes. These funds are just another Wall Street product that lulls investors to sleep by promising more benefits and risk control than they are likely to provide.

I've received many postcards in the mail from Fidelity Investments offering 200 free trades if I open a new account. Investors who accept this offer will likely discover that 200 free trades will cost them more money than they can imagine.

An investment guru is someone who has discovered that they can make more money telling others how to invest rather than investing money themselves. Anyone who could predict the future performance of stocks or the economy would invest their own money, make a fortune and keep quiet. They wouldn't waste their time giving advice or managing other people's money.

The problem with conventional wisdom it is that it often substitutes for clear thinking.

Over the past several decades, the proportion of active mutual funds that add value for their investors (net of fees and costs) has steadily declined. There are skilled active fund managers. Unfortunately for their investors, most of the benefits of their skill accrues only to themselves because their excess return rarely exceeds their fees and trading costs. This makes active portfolio management unique in our consumer economy because investors are unable to identify real value before – and often after – buying the product.

Don't get me wrong – I love active managers. Without them, it would be difficult to know the fair price of a stock. It's the frantic trading of active managers that leads to consensus opinion pricing that incorporates all publicly available information about a stock. They create liquidity in the stock market; allowing investors to buy or sell a stock quickly without high costs or price impact. There’s an ongoing debate about the degree of the stock market’s pricing efficiency.

But the market doesn't have to be perfectly efficient to be better at pricing stocks than any individual participant. As long as there's the slightest chance to outperform the market, there'll be a multitude of active investors who will attempt to do so. May they live long and continue in their delusion.

For passive investing to be successful, there must be active investors. The cost of research and information gathering necessary to make a liquid, efficient market is borne by active fund investors. Index investors get a free ride because we accept consensus pricing as "fair" and don't pay the "price discovery" costs of active management. This is like the relationship I have with PBS. I don't donate to PBS but I'll still watch programs that interest me.

Investing professionals think of themselves as the "smart money" and consider individual investors to be the "dumb money." But trying to outperform the market has always been a loser's game, no matter how smart you are or how many billions of dollars you manage. The truth is that the "smart money" is, more often than not, the "dumb" money".

Diversification is the central tenet of prudent portfolio construction. Investors can obtain all the diversification they need with low cost mutual funds and exchange traded funds. They don't need the complex, actively managed, expensive, non-traded or alternative investments routinely promoted by Wall Street.

Broad diversification, maintaining a long-term mindset and having the discipline to stick with your strategy is the type of advice that bores people. But most successful investors will admit that their investing life has been quite boring.

In 1900, 40% of American workers worked on farms. By the year 2000 that number had declined to only 3%. If the average American in 1900 had known this, he would have assumed that America in the year 2000 would be a third world country populated by starving, unemployed, poverty stricken citizens.

Markets don't produce risk. Panic selling in 2008 or 2002 was self-inflicted risk. The market decline wasn't the problem; the decision to sell during and after the decline was the real risk.

The longer your investment time horizon, the more compounding works in your favor. That's why it's important to start early. Unfortunately, the people with the longest investment time horizon are those with the fewest dollars to invest.

Financial planning is all about managing risk. More precisely, managing your asset allocation - the heart and soul of any portfolio. Wall Street promotes too many investment fads and strategies instead of sticking with the traditional asset classes that have stood the test of time. Its mantra is "Newer is better".

The main function of high quality bonds in your portfolio is to act as a volatility reducer – they're not capital appreciation assets. Think of them as an anxiety management tool.

There are two keys to staying on course during bear markets. The first is that you shouldn't have a stock allocation that produces more volatility than you can tolerate. The second is to know financial history which will provide perspective to understand that it's not different this time and that panic selling rarely accomplishes anything.

The biggest problem with trying to beat the market is that it isn't necessary. Most investors just need to generate market equaling returns to meet their long-term financial goals – one that outpaces inflation and doesn't expose you to unnecessary risk.

It seems that millennials can't keep their noses out of their cell phones. If you answer work emails after hours, on vacation or on weekends, your suffering from the delusion that work is more important than quality of life. Someday, you'll realize the folly of that idea.

The stock market resists prophecy. Let me revise that. The stock market plunders pundits and gives overconfident investors exactly what they deserve.

It amazes me how much human ingenuity has been devoted to creating investment scams.

In years past, the possession of wealth brought with it the implication of intelligence. Today, not so.

When Thomas Edison invented the light bulb, he extended daylight. But he also accomplished a feat which, to my way of thinking, was more noteworthy – he separated light from fire.