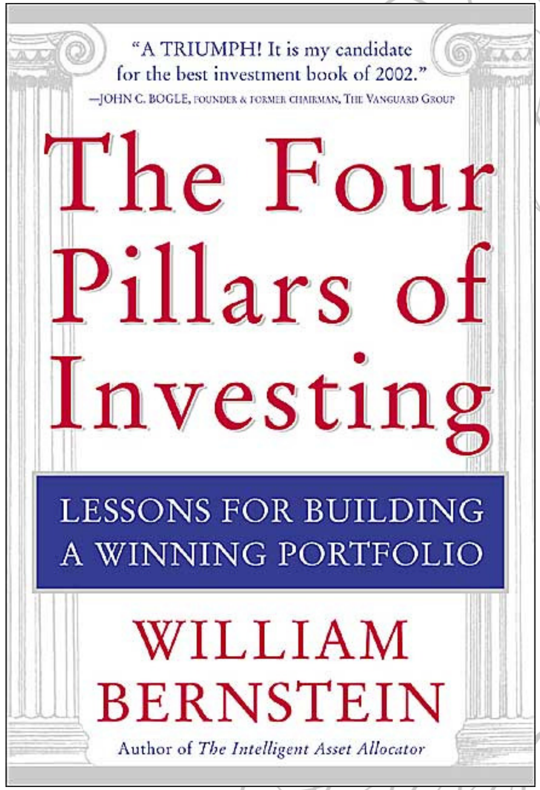
The Four Pillars of Investing

William Bernstein © 2002

Bernstein's overview of the four "pillars" of personal investment strategy is an important starting work for anyone knew to investing and one of the best all-round investment books. It is also is a challenge to many commercial operators in the industry who would rather you not read this book.

1. **Investment Theory**
   - **Investors are rewarded for exposure to risk. You are not rewarded for the risk of trying to pick the next best fund or stock**
2. **History of Markets**
   - **"From time to time, markets and investors go barking mad … from psychotically euphoric to toxically depressed" … and such madness is only visible in retrospect**
3. **Psychology of investing**
   - **Behavioural science teaches us about many human behaviours that lead us to become overconfident and make irrational decisions**
4. **Business of investment**
   - **"Brokers are not your friends" and the "interests of fund companies are highly divergent to yours"**



ISBN 0-07-138529-0
McGraw Hill

1. Theory – too many focus on the wrong things

Are the markets rational?

'My answer is that it all depends on your time horizon. Turn on CNBC at 9:31AM any weekday morning and you're faced with a lunatic asylum described by the Three Stooges.

But stand back a bit and you'll start to see trends and regular occurrences. When the market is viewed over decades, its' behaviour is predictable'.

Random walk

' … likens the market to an excitable dog on a very long leash in NY city, darting randomly in every direction.

The owner is walking from Columbus Circle through Central Park to the Met. At any one moment, there is no predicting which way the pooch will lurch.

But in the long run, you know he's heading northeast at an average speed of 3 mph.

What is astonishing is that almost all of the market players, big and small, seem to have their eye on the dog not the owner'.

Trends and regular occurrences

Investing is about earning a return for shouldering risk

Return on capital, adjusted for risk, is the same [Modigliani, Miller – Nobel prize winners]

Longer a risky asset is held, lower the chance of loss

When political and economic outlook is the brightest, returns are the lowest, when things look the darkest the returns are the highest

Real (inflation adjusted) returns of stocks have been about 6%, bonds 1% and cash nil

Over the long term, small companies provide a greater return than large, poorly run unglamourous companies return more than glamourous, better run companies

- **Risk is higher, therefore prices are lower, potential returns are greater, especially if you hold a diverse portfolio of those types of equities**
  - **'Good companies are generally bad stocks, and bad companies are generally good stocks'**

Over the long run, corporate earnings growth produces stock price increases

Stocks generally mean revert (i.e. good return periods can be followed by poor periods)

Following several decades of out-performance, future returns of stocks and bonds could be lower, eg. 3.5% real return, not the 6-7% historical return.

Active managers don't add value

As early as 1930s, research [Alfred Cowles] appeared to suggest most active fund managers don't beat the market, especially after fees

Forecasters, strategists, economists consensus opinion "underperforms the market ¾ of the time"

The only evidence of performance consistency with money managers is that the bottom 20% tend to stay there far more often than explained by chance

Even today institutional pension plans allocate a significant proportion of funds to active managers in spite of evidence showing most would be better off indexing

'Fund managers know only two things: 1) like everybody else, they don't know where the market is headed, 2) their livelihood depends on appearing to know'

Collective judgement of all experts of what a stock or bond is worth is its' market price

Your best option is to own the whole market via a low-fee and low-tax index fund

- Yes you will give up the chance of exceptional returns, but also exceptionally poor returns and you will enjoy lower fees and taxes

You cannot adequately diversify over the long term holding a small basket of direct shares

'Since you cannot successfully time the market or select individual stocks, asset allocation should be the major focus of your investment strategy'

2. When markets go berserk (history of investing)

'From time to time, markets can become either irrationally exuberant or morosely depressed'

- **In good times, remember that things can go to hell in a hand basket**
  - **During good times, future returns can be the lowest**
- **In bad times, things almost always turn around**
  - **During bad times, future returns can be the highest**
  - **Eg. bad times: from 1973 to 1979, DJI moved from 1000 to 875 (today 10,000)**

'How to handle the panic'

- **Maintain a firm asset allocation**
  - **'Do not underestimate the amount of courage it takes'**
- **Rebalance: sell what has gone up, buy what has gone down**

And for the future?
'Possibility of a period of low returns and pervasive pessimism'

3. Behavioural investing

Central premise is that we are not programmed to be good investors

- **The intuition that helped us survive sabre tooth tigers, doesn’t always help us be good investors**

Beware of …

- **Fashion or following the herd: most topical investment may be overpriced**
- **Overconfidence: 'the average investor believes he will beat the market by 2%'**
- **Compartmentalising success and failure: Attribute luck to skill, forget failures**
- **Recency: eg. focusing on past performance despite evidence equites mean revert**
- **Entertainment: like gambling, people gravitate to low probability, high returns**
- **Focusing on short term: 'we feel more pain losing 30% suddenly, than the more damaging possibility of failing to meet our long term goals'**
- **Searching for patterns: 'world’s wealthiest people would be librarians if patterns repeated'**
- **Becoming a 'whale' (the cash cows of the investment industry who are bled with commissions associated with exotic products sold to wealthy investors)**

'The biggest obstacle to your investment success is staring at you from your mirror'

4. On the business of investing

Bernstein is not a friend to all in the financial industry, he believes …

Brokers are not your friends, they are poorly trained stock 'sellers' whose performance is never benchmarked, and are conflicted by service to their institutional clients

- **'Just bypass them'**

Investors have to tread carefully employing fund managers whose main goal is to accumulate assets not deliver cost-effective investment performance

- **Funds management is at least more transparent than stockbroking**

'Ninety nine percent of what you read and hear from the financial media is advertising cloaked as journalism'

- **Money managers and financial press 'desperately need each other' (this is not unique: consider fashion, automobiles, travel reporting)**
- **1999 *Fortune* 'Unfortunately, rational, pro-index fund stories don't sell'**

The market is your best advisor (you are hiring the aggregate judgement of the experts)

The only real guidance you need is on your overall asset allocation and self-discipline *[and we add investment structuring in the complex Australian environment]*

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About Professional Wealth

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