

**BURTON G. MALKIEL**

*Bestselling author of *A Random Walk Down Wall Street**



**THE  
ELEMENTS  
OF  
INVESTING**



**CHARLES D. ELLIS**

*Bestselling author of *Winning the Loser's Game**

**BURTON G. MALKIEL**

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**Burton G. Malkiel  
Charles D. Ellis**



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To our delightful grandchildren, Porter, Mackie, Jade,  
Morgan, Charles, and Ray



# FOREWORD

In *The Elements of Investing*, Charley Ellis and Burt Malkiel, two of the investment world's greatest thinkers, combine their talents to produce a remarkable guide to personal finance. Having already written two of the finest books on financial markets, Ellis's *Winning the Loser's Game* and Malkiel's *A Random Walk Down Wall Street*, why should the authors revisit the subject of their already classic volumes? The sad fact is that in the cacophony of advice for individual investors, few sane voices are raised. In writing *The Elements of Investing*, the authors provide an important service to the lay reader, honing their message to the bare essentials by heeding Albert Einstein's dictum that "everything should be made as simple as possible, but not simpler."

Investors have three tools to deploy in the portfolio management process—asset allocation, market timing, and security selection. Asset allocation involves setting long-term targets for each of the asset classes in which an investor invests. Market timing consists of short-term bets against the long-term asset allocation targets. Security selection deals with the construction of the asset classes that an investor chooses to employ.

Ellis and Malkiel correctly focus on asset allocation since asset allocation accounts for more than 100 percent of investor returns. How can it be that more than 100 percent of returns come from the asset allocation decision? Market timing and security selection involve significant costs in the form of management fees paid to outside advisors and commissions extracted by Wall Street brokers. Such costs ensure that investors will underperform by the totality of

investment management costs, which represent transfers from investors to their agents. Hence, the expensive activities of market timing and security selection reduce the returns available for the community of investors and that is the reason asset allocation explains more than 100 percent of investor returns.

Ellis and Malkiel observe that investors consistently make perverse market timing decisions, chasing hot performers and dumping laggards. Study after study of mutual fund trading concludes that investors buy high and sell low, subtracting value with their timing decisions. Ellis and Malkiel sensibly advise investors to adopt a coherent long-term strategy and stick with it.

Security selection decisions further reduce returns. Ellis and Malkiel cite depressing statistics regarding the failure of the majority of mutual fund managers to exceed the returns of low-cost, passive, market-matching index strategies. The documented dismal numbers only begin to capture the enormity of the situation. Ellis and Malkiel cite numbers only for funds that survived, a relatively successful subset of the mutual fund universe. The failures, which as a group produced miserable returns, are nowhere to be measured. Many funds disappeared. The Center for Research in Security Prices collects data on all mutual funds, dead or alive. As of December 2008, the Center tracked 39,000 funds, only 26,000 of which are active. The 13,000 failed funds do not show up in the authors' studies of past returns because the failed funds do not have current track records. (They disappeared, after all.) Considering the experience of mutual funds, dead and alive, reinforces Ellis and Malkiel's advice to take the low-cost, passive approach.

Of course, even in a slim volume, quibbles arise. I view home ownership more as a consumption good and less as an investment asset. I cast a skeptical eye on Ellis and

Malkiel's implicit endorsement of stock picking in their confessions regarding personal success in security selection. (Is it surprising that two of the greatest figures in modern finance would figure out how to beat the market? Yes, they can pick stocks—the rest of us cannot.) I more emphatically recommend Vanguard, which, along with TIAA-CREF, operates on a not-for-profit basis and thereby eliminates the money management industry's pervasive conflict between profit motive and fiduciary responsibility. Quibbles aside, *The Elements of Investing* delivers an important and fundamentally valuable message.

When I was a doctoral student at Yale in the late 1970s my dissertation advisor, Nobel laureate James Tobin, suggested that I read *A Random Walk Down Wall Street* to learn about how markets really work. Burt Malkiel's wonderful book provided a critical foundation for my academic work. When I returned to Yale in the mid-1980s to manage Yale's endowment, I came across *Investment Policy*, the predecessor to *Winning the Loser's Game*. Charley Ellis's marvelous volume informed my approach to investment management in countless ways. Now, Charley Ellis and Burt Malkiel have produced a magnificent primer on investing for all of us. Follow their recommendations and prosper!

David F. Swensen

Author of *Unconventional Success:*

*A Fundamental Approach to Personal Investment*

Chief Investment Officer, Yale University

July 2009

# INTRODUCTION

In 100 years of study and experience,<sup>1</sup> here are the Elements of Investing we wish we'd always known. Experience may well be the best teacher, but the tuition is very high. Our objective is to provide individual investors—including our delightful grandchildren—the basic principles for a lifetime of financial success in saving and investing, all in 176 pages of straight talk that can be read in just two hours. There are many good books about investing. (Indeed, we've even written a few ourselves.) But most investing books run to 400 pages or more and go into complex details that tend to overwhelm normal people.

If you're like most people, you have neither the patience nor the interest to plow through that much detail. You want to get the main things right. Still, having unbiased information about financial decision making and avoiding costly investing errors is critically important.

That's why we present the most important lessons in this easy-to-read, jargon-free little book. If you happen to be familiar with William Strunk Jr. and E. B. White's classic book, *The Elements of Style*, you will recognize one of the original sources of inspiration for this book—and why we are so brief. If you are unfamiliar with Strunk and White, don't worry. All you need to know is that they whittled down the art of powerful writing to a few basic rules of usage and composition. In less than 92 pages, they shared *everything* about writing that truly mattered; brevity and precision became instant virtues. Strunk and White's wafer-thin classic has chugged along for decades. No doubt it will outlive us all.

We now dare state our goal on the equally important topic of investing. How surprising to us that *everything* of importance on such a heady topic can be reduced to rules you can count on one hand. Yes, investing can be that simple if your brain remains unclouded with taxing complexities. These rules will truly *make a difference*.

Our promise: Reading this book will be the best time you could spend to put yourself on the right path to long-term financial security. Then, over your lifetime, you can pick this book up again to scan its lessons and remind yourself what is elemental if you want to turn a loser's game into one you can really win.