

MARKETS NEVER FORGET



But
People
Do

How Your Memory Is Costing You Money—
and Why This Time isn't Different

KEN FISHER

New York Times bestselling author

with Lara Hoffmans

**MARKETS NEVER
FORGET
(BUT PEOPLE DO)**

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John Wiley & Sons, Inc.

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Published by John Wiley & Sons, Inc., Hoboken, New Jersey.

Published simultaneously in Canada.

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Library of Congress Cataloging-in-Publication Data:

Fisher, Kenneth L.

Markets never forget (but people do) : how your memory is costing you money and why this time isn't different / Ken Fisher with Lara Hoffmans. —1st ed.

p. cm.

Includes index.

ISBN 978-1-118-09154-8 (hardback); ISBN 978-1-118-16760-1 (ebk);

ISBN 978-1-118-16761-8 (ebk); ISBN 978-1-118-16762-5 (ebk)

1. Investments. 2. Portfolio management. 3. Finance, Personal. I. Hoffmans, Lara.

II. Title.

HG4521.F5848 2011

332.6—dc23

2011037193

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

To Bob Hope—Thanks for the memory.

Contents

Preface	ix
Acknowledgments	xvii
Chapter 1 The Plain-Old Normal	1
Yes Sir, Sir John	1
The Normal Normal	5
The Jobless Recovery	14
The Always Feared, Rarely Seen Double Dip	23
Chapter 2 Fooled by Averages	31
Bull Markets Are Inherently Above Average	32
Viva the V	36
Normal Returns Are Extreme, Not Average	47
The Pause That Refreshes (and Confuses)	49
Getting Average Returns Is Hard—Really Hard	53
Chapter 3 Volatility Is Normal—and Volatile	57
What the Heck <i>Is</i> Volatility?	58
Volatility Is Volatile	61
The Daily Grind	65
Stocks Are Less Volatile Than Bonds?	67
Economic Volatility—Also Normal	69
Volatility Isn’t Inherently Bad	71
Never a Dull Moment	74

Chapter 4	Secular Bear? (Secular) Bull!	81
	Seeing the World Through Bear-Colored Glasses	82
	Two Secular Bear Markets?	84
	Stocks—Up Vastly More Than Down	90
Chapter 5	Debt and Deficient Thinking	101
	Deficits Aren't Bad, but Surpluses Will Kill You	105
	The History of Big Government Debt	110
	Just Who Is at Default Here?	116
Chapter 6	Long-Term Love and Other Investing Errors	123
	No One Category Is Best for All Time	124
	Long-Term Love Is Like Long-Term Forecasting— Both Wrong	129
	It's Still Heat Chasing Even When It Seems Safe	134
	Use History to Your Advantage	146
Chapter 7	Poli-Ticking	151
	Enter the Ideology-Free Zone	152
	Your Party Isn't Better	153
	Presidents and Risk Aversion	155
	Perverse Inverse—It's Four and One	160
	Poli-Tics Go Global	170
	Poli-Tics Versus Entrepreneurs	172
Chapter 8	It's (Always Been) a Global World, After All	177
	It's Always Been a Small World	179
	Seeing the World Right	186
	Conclusion	194
Appendix		197
Notes		201
Index		211

Preface

Hope Springs Eternal

Bob Hope (1903–2003) was huge when I was young. Funny, funny, funny! Whether in the *Road to . . .* movies with Bing Crosby (Hope was in 52 major flicks), with the US armed forces overseas wherever conflict occurred at his own personal danger, on TV, doing stand-up, etc., Hope was everywhere. And every performance since 1938 included his anthem, *Thanks for the Memory* (words by Leo Robin, music by Ralph Rainger and first recorded by Hope and Shirley Ross). Hope was huge and beyond great. And hope springs eternal. Then and now! But sadly, our memories aren't so functional. Fact is, our memories are beyond terrible when it comes to economic and market realities.

People forget. So much! So often! So fast! Stuff that happened not long ago—and more often than not. And it causes investing errors—pretty commonly humongous ones. Maybe Hope should have been singing, *Pranks for My Memory*. Because for a fact, our memories play pranks on us in markets, and always have and we never learn.

We forget facts, events, causes, outcomes, even *feelings*. And because we forget, we tend to be hyper-focused on the here-and-now and immediate past—behavioralists call it *myopia*. We tend to think what we see is new and different—and significant—when pretty often, we've seen the exact same thing before or something very close to it and history is littered with similar examples.

This species-wide tendency to myopia isn't accidental—it's evolutionary. Humans evolved over millennia to forget pain fast. If we didn't, we wouldn't do crazy things like hunt giant beasts with sticks and stones or plow our fields again after drought, hail, fire, what-have-you destroyed our crops. And for sure no female would ever have more than one kid. But we do forget, and fast.

Forgetting pain is a survival instinct, but unfortunately, that means we also forget the lessons. Then, too, though people individually forget, markets don't. History does not, in fact, repeat—not exactly. Every bear market has a distinct set of drivers, as does every bull market. But human behavior doesn't change—not enough and not very fast to matter. Investors may not remember how panicked or euphoric they were over past events. They may not remember they had the exact same repeating fears over debt, deficits, stupid politicians, high oil, low oil, consumers spending too much, consumers not spending enough, etc., etc., etc. But markets remember very well that details may change but behavior generally doesn't.

For decades, I've heard otherwise intelligent business folks express (as fact) opinions about current phenomena being extreme, when history shows they're not extreme or even unusual. Examples are plentiful and throughout this book. But if you point out to someone that his opinion-stated-as-fact is actually false, you will run into a brick wall because he simply won't believe it. They *know*. They read it in the media or online. Their friends agree. It's a fact to them. It may also be a false fact and one easily known if we didn't simply forget so easily. But because we forget as individuals, we do so as a society, too.

This is why investors, as a group, make the same mistakes repeatedly. Don't think investors are error-prone? CXO Advisory Group measures so-called gurus—folks who make public market forecasts in a variety of forums. Some also manage money professionally (as I do—they include me in their guru rankings); some don't and instead do newsletters, write columns, etc. But everyone on the list is a professional in some way at making public market proclamations.

And the average accuracy of this group, as measured by CXO? As I write, it's 47%.¹ (See Chapter 1 for how they rate me.) I can't ever recall seeing that average over 50%. And these are pros! This group of well-known, professional market prognosticators is, on average, right *less than half the time!* If that's the case, you know non-professional do-it-yourselfers can't have a much better record. (In fact, the average non-pro investor likely does much, much worse. See Chapter 2.)

We Can't Remember That We Forget

Why do investors fail to be right even half of the time? A huge single reason: We forget! And hence, we don't really learn from past mistakes. Investors get overwhelmed by greed or fear but also forget that

being greedy or fearful didn't work out for them in the past. But they *also* forget they were wrongly greedy or fearful because feelings *now* seem so much stronger (even though they're probably not).

They get head-faked by what later turns out to be normal volatility—because they forget they've lived through volatility many times before. They overreact—either too bearish or too bullish—based on some widely dispersed media report that later turns out to be highly overstated or just plain wrong and often backward. Why? They forget the media is often and repeatedly wrong for the exact same reason—it's made up of humans.

They get terrified, for example, by huge market volatility in 2008 that's fairly consistent with the bottoming period of any bear market, though they lived through something similar in 2003 and more so in 1974. And they missed the huge boom off the bottom in 2009—never could imagine stocks could move up so fast—though we saw something similar (to a lesser degree) in 2003. (And 1975–1976—and again and again and again in past bear markets and new bull markets—but 2002 and 2003 were just a few years ago and investors should at least remember that!)

Yes, 2008 was volatile relative to recent history, but not compared with a bit longer history—but investors forget to check history, too. Learning from history is scant in our world. First, history is usually boring to most. And second, most folks can't quite believe in their myopic minds that what happened a few too many decades ago has any bearing on today. In reality, markets don't change much in the basics of how they function because the people whose interactions make them work don't change much over time. One of the most basic lessons of behavioral psychology is that humans are slow to change and learn.

More examples: Investors believe *their* favorite politician from *their* political party is just better for stocks, even though very recent history should teach that no one party is better or worse overall for stocks (Chapter 7). They think their favorite asset class is just better over time, forgetting the not-so-distant past when they were proven wrong (Chapter 6). And they forget that they forgot the last time because it is too painful to do otherwise! And the time before that! Repeatedly making the same errors based on the same misunderstandings and misperceptions.

Fortunately, you needn't be right 100% of the time to do well at investing. Such a thing is impossible. And if you're banking your financial future on being 100% right, you'll be sorely

disappointed—for a fact—because no one is ever right all the time. Rather, you want to aim to be right more than wrong. The all-time best investors were wrong an awful lot. In investing, if you're right 60% of the time, you're a legend—and 70% of the time you're a god. Just being right slightly more than 50% of the time means you likely do better than most investors—including the overwhelming bulk of investment professionals.

In my view, a good way to improve your results is aiming to reduce your error rate. If you see the world more clearly and don't fall prey to the same misperceptions that plague most other investors, you can start making fewer mistakes. This is, in essence, what most of my books, *Forbes* columns and other writings are about and have always been about—looking at the world and trying to see it differently but more correctly (in my view) and then determining how to act or not act—all largely centered on error-rate reduction. And you'll still make lots of errors, but that's ok.

And one great tool for seeing the world more clearly and reducing your error rate is simply improving your memory by a steady and regular application of even just a bit of market history. This book shows you how.

History as a (Powerful) Lab

If you go to work tomorrow wearing a green shirt and say, "I'm going to win a million dollars today because everyone knows when you wear a green shirt on Tuesdays, you win a million dollars," your colleagues will grab a giant butterfly net. You're predicting an outcome that 1) has no historical precedent and 2) lacks any rooting in reality. You see that clearly.

Yet every time I talk about history's role as a powerful tool in capital markets forecasting, inevitably some say, "Past performance is no indication of the future!" Well, that's not why you should look at history. Use history as a laboratory—to understand the range of reasonable expectations. For example, when event X happens, the outcomes are usually B, C or D, but can be anywhere from A to F. So I know that anything could happen, but odds are greater something like A through F happens, with odds still higher on B, C and D. And the odds of something outside that range happening is very, very low, so it would take exceptional extra knowledge to bet on something like that happening.

Then, too, you should consider other factors that might affect the outcome—the world of economic, political and sentiment drivers. Maybe Event Y is happening simultaneously, which likely reduces the odds of D happening and increases B. Heck, maybe Event Z is likely to happen soon, which usually near-guarantees a Q, so even though it's an outlier, I know to throw that into my bucket of probabilities. That's how I would have you think—in terms of the probabilities. At its basics, investing is a probabilities game; it's not a certainties game.

But what's interesting is the same people who huff that history isn't a useful guide will still say, with absolute certainty, things like: "This high debt will ruin the economy and drag down stocks." Or, "The economy can't recover with high unemployment." Really? And what's the basis for that?

Presumably, if you say with certainty some condition leads to some other condition, that's because you've *observed that in the past* or can otherwise measure it historically. Either that, or sound economic fundamentals says it must be so. Fair enough? And if a lot of people say Event X must cause Outcome Y, there's no harm in checking to see if that's what happened historically most of the time. Because if it hasn't happened before, it's unlikely to happen now whether most folks think it will or not.

Yet most people in the media, blogosphere or social circuit go nuts when I say there's absolutely no historical precedent—zero—for this particular thing causing that particular outcome once it has become socially accepted that it will. I'll not cite facts and history here—because we will later in the book. But more often than not, things people think of as new, bigger-than-ever, worse-than-ever and certainly causal of predictable outcome are things we've seen many, many times before and can document don't cause the outcomes that are widely and socially expected.

Critics love to criticize the use of market history to debunk widely held views. Yet when people claim things like the economy can't expand because unemployment is too high, *they too are trying to make a historical claim*. Just so happens theirs doesn't hold up since we have a long history of levels of unemployment here and around the world to measure the claim against. In effect, saying high unemployment causes economies to slow or stocks to tank is identical to the magic green shirt claim. It provably isn't so. It's not observable in a lab (i.e., history), and it makes no economic sense for a firm to start aggressively hiring if its sales haven't recovered.

Sometimes, weird stuff happens. You wear your magic green shirt and you *do* win the lottery! Hooray! But no one in their right mind would bet on you winning the lottery again, even if you wore your green shirt and bought 1,000 lottery tickets. Winning the lottery is a *possible* outcome—the odds are just near-immeasurably low. And there's not good evidence the green shirt was a material driver in the previous win. And that you may feel good in green (my favorite color) doesn't change the odds one iota.

That's why history is powerful. Investing, as said earlier, is a probabilities game, not a certainties game. No one can ever say with any certainty what will happen. (Anyone claiming otherwise is probably trying to sell you something very bad for you—or just rob you blind.) Just so, while investing is a *probabilities* game, it's not a *possibilities* game. It's possible you wear a green shirt and win a million dollars! It's possible an asteroid hits Earth and obliterates life as we know it. It's possible you buy a penny stock that turns out to be the next Microsoft. There are endless, almost infinite possibilities. But you can't bet on things just because they are possible. You can't build an investment portfolio around endless possibilities—whether good or bad. (You probably wouldn't get out of bed in the morning if you dwelt on every possibility.) You must instead consider the range of likely outcomes and then form forward-looking expectations based on probabilities. You will be wrong—a lot. Expect it. But if you can craft reasonable probabilities, you likely start getting better results over time (while still being wrong an awful lot).

If you suffer memory loss, that gets very tough to do. But if you remember that you have a lousy memory and can train yourself to use history to understand probabilities, you can better understand what's likelier (or not at all likely) going forward. And you can begin reducing your error rate.

A Walk Down Memory Lane

Throughout the book, I use quotes from old news stories. They're meant to be illustrative, not comprehensive. For example, if I want to show that people frequently fear a double-dip recession early in a new recession—and this isn't a new phenomenon indicative of uniquely new trouble—I show a selection of historic quotes from older news stories. They're meant to show the sentiment existed. Could I have found quotes saying, “No way! Double dippers are

crazy! There'll be no double dip," to counter every instance? Sure! But I don't think that's useful to you.

Typically, people tend to seek things reconfirming what they already believe and ignore or discount things not supporting their worldview. This is a known cognitive error people who study all forms of behavioralism (including behavioral finance) call *confirmation bias*. We find evidence to confirm our biases and make ourselves blind to evidence contradicting them. Behavioralists have documented why this is basic to the human condition of successful evolution. It makes us more confident and willing to try harder repeatedly in the face of the brutishly difficult conditions we've faced in normal human evolution. But it hurts in markets.

Further, more investors are prone to be naturally skeptical—bearish—than are prone to be naturally optimistic. Not always and everywhere, and even the most dug-in bears can have times when they're euphorically bullish (though it's usually a bad sign when dug-in bears become bullish). But overwhelmingly, since stocks rise much more than fall (over two-thirds of history), folks counterintuitively tend to be bearish more than bullish. That concept—that people overwhelmingly tend to be fearful when they shouldn't—is at the very core of why so many fail to get the long-term results they want. It's behind the quote Warren Buffett is famous for (though it's not his—he just made it broadly popular): You should be greedy when others are fearful and fearful when others are greedy.

I'm not advocating contrarianism. That doesn't work, either. Just because people mostly think one thing doesn't necessarily mean the opposite will occur, which is the pure definition of contrarianism. Instead, I advocate not blindly following the herd.

The fact is, most people, if already bullish or bearish, usually seek out and believe news stories and pundits supporting their existing view. So yes, you can find plenty of news stories that rationally say at any given time, for example:

- A recession isn't likely.
- This is likely just a correction.
- Global growth is fine.
- Corporate profits are healthy; don't panic.
- And so on.

But if you fail to remember history and are misguidedly bearish more often than not, you likely discount the non-alarmist stories and

seek out those who bolster the views you want to have anyway. Ditto if you're misguidedly bullish. Which is why I decided to highlight just a smattering of quotes instead of turning this into an 800-page academic tome. (Plus, it's just fun to see how in history, people have the same exact fears we have now and will have 1, 3, 7, 23 and 189 years into the future.)

So feel free to quibble with the quotes I pulled. I don't expect to change most readers' views because I know most readers are hard-wired to find evidence that confirms their prior biases and make themselves blind to evidence that contradicts them.

But you should feel free to have fun with your own hunt for past stories, headlines, quotes—Google's timeline feature is simultaneously useful and insanely fun. The *New York Times* also has a huge archive of past issues you can access online. And any decent-sized library will have tons of back publications on microfiche—a bit less high-tech than Google but will surely bring back memories of study carrels in the college library (if that's your thing). My point is, none of the sentiments or behaviors I write about here are anything new. And you can use that to your advantage if you can start using history as a tool to counteract what can sometimes be a faulty memory.

Also, this is my eighth book—which I can hardly believe. Though my outlook from year to year changes based on my expectations for the next 12 months or so, my overriding worldview changes much less. I'm a firm believer in capitalism and the power of the capital markets pricing mechanism. As such, I believe supply and demand are the two primary determinants for stock prices—though there are myriad factors impacting both supply and demand.

Therefore, if you've read my past books, you may notice some charts are repeated in some books (though updated with the most recent data). And that's intentional—if there's a powerful way to illustrate some concept, I don't mind re-using that. However, I may describe the chart in a new way or use it in an entirely new context. In fact, in this book I use quite a few charts from my 1987 book *The Wall Street Waltz*—many of them were too good to not use again. After all, in a book about the usefulness of history, I think it's only fair I use a bit of my own history. So I hope you'll forgive me if you've seen some images before—some market truths endure not just the decades of my 40-year professional career but much, much longer.

So let's get to it!

And thanks for the memory.

Acknowledgments

I'm a history buff. I'm a maniac over nineteenth-century steam-era redwood lumbering history—which links to my love of tall trees, particularly redwoods. But I'm also a fan of market and economic history. The redwoods are a hobby, whereas the latter is a hobby that is also a profession I love dearly. So the idea of writing a book (another hobby) about using history seemed like an idea whose time had come. I've written two before (*The Wall Street Waltz* in 1987 and *100 Minds That Made the Market* in 1993), but not for a long, long time and not one like this.

Not only that, but as I write this in 2011, we've just been through a period many called *historic* and *unprecedented*—the 2008 credit crisis, recession and the big 2007–2009 bear market. In many ways, it was historic—a big bear market and an above-average recession. But in many other ways, it was just another bear market. The differences tend to be over-accentuated in our social psyche and the similarities downplayed. The causes were different—they almost always are. But investor behavior into and out of the bear market was pretty standard. In 2010 and even 2011—after the recession was long over—investors were still saying, “This time it's different,” and fearing all the same events that had triggered the recession three years prior—though the market had a historically huge surge from its low and global GDP was at all-time highs. But investors almost always disbelieve the recovery and routinely believe the world is irrevocably and fundamentally changed—though it almost never is.

So I decided now was as good a time as ever for a primer on how to use history—not as a silver bullet for forecasting the future (such a thing doesn't exist) but as one additional tool investors can add in the non-stop query session that is capital markets forecasting.

A book is never the work of one person. And a book written by the CEO of an investment firm with tens of billions in assets under management by definition requires a strong supporting cast. Books

are a leisure time activity for me, and as the years pass, I find I have ever more demands on my non-working hours. So I must thank Lara Hoffmans—who not only writes endlessly for me and my firm, but manages a group of writers and is managing editor of my firm’s daily webzine, *MarketMinder*. For this, my eighth book and our fifth book together, she once again did the grunt work in drafting outlines from my specifications and guidelines for my approval, then providing very polished drafts. She does the hard work, and I have all the fun of conceiving it and then stylizing it—an ideal situation. Not as good as grandchildren—nothing better than that—but pretty darned fun, nonetheless.

Lara has a day job, too—and it seems each year I yank her from it. So I must thank her team for backstopping her while she works on my book. That includes Dave Eckerly, Group Vice President of Corporate Communications, who helped Lara’s team load balance, and also Todd Bliman and Amanda Williams—also firm writers who shouldered some of Lara’s non-book writing responsibilities with aplomb (and very fine writers in their own rights). Thanks also to Naj Srinivas, Elisabeth Dellinger, Ashley Muth and Evelyn Chea—also members of Lara’s team who took on many more of her offloaded tasks. Jake Gamble assisted Lara in running down many of the quotes in the book. My sincere thanks also go to Aaron, Lara’s husband, who must deal with her being preoccupied at night and on weekends during what’s become annual book season.

Leading the team that provided all the graphs, tables and every datapoint you see in the book was Matt Schrader, Team Leader of our Research Analysis and Production team. Handling most of many day-to-day requests was Danielle Lynch. It’s no easy feat providing data for one of my books—we (mostly Lara) double check, triple check, question, challenge and demand duplicate and triplicate confirmation. Theory is fine but doesn’t hold water if you can’t somehow prove it—and for that we want our data to be sound. Danielle gamely handled it all and never broke a sweat in what is inherently a very sweaty process.

Leila Amiri, a graphic designer at my firm, designed what I think is a very cool cover. Molly Lienesch, Vice President of Branding, always provides excellent advice on positioning the book. And Fab Ornani, Vice President of Marketing Content and resident web guru and Jim Smolinski, Group Vice President of Marketing,

assist in our marketing efforts—which my publisher, John Wiley & Sons, likes very much.

As always, many thanks to Jeff Herman, my excellent agent, who led me to John Wiley & Sons. Speaking of Wiley, I must thank Laura Walsh, who is our very patient editor there. She and the rest of the Wiley team, Judy Howarth, Sharon Polese, Nancy Rothschild, Jocelyn Cordova-Wagner and Tula Batanchiev, quite literally make the book what it is. Putting up with me isn't always so easy, and they make it seem very easy, indeed!

I must also thank Jeff Silk and Andrew Teufel, both Vice Chairmen at my firm, and Aaron Anderson and William Glaser. Although they didn't contribute to the book, those four fine gentlemen assist me in guiding portfolios at my firm. They also help me think. Running the business of the firm day to day are Co-Presidents Steve Triplett and Damian Ornani. My firm couldn't be the success it continues to be without those six, and if my firm weren't a success, I doubt anyone would want to read so much as a haiku if I'd written it. I also don't think I'd be able to take the time to create such a work today.

I've saved the most important for last. Sherrilyn, my wife of 41 years. Time on the book is time away from her and my family. I'm eternally grateful for her patience and eternally grateful for her.

KEN FISHER
Woodside, CA

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