

New York Times Bestseller!

THE ONLY
THREE
QUESTIONS
THAT
STILL COUNT

Investing by Knowing What Others Don't

KEN FISHER

CEO of Fisher Investments and *Forbes* columnist

with Jennifer Chou and Lara Hoffmans

Fully Revised and Updated

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WILEY

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P R E F A C E

Who Am I to Tell You Something That Counts?

Who am I to tell you anything, much less anything that counts? Or that there are only three questions that count and I know what they are? Why should you bother reading any of this? Why listen to me at all?

As I update this book in 2011 for its second edition, I've been in the investment industry for nearly 40 years. I founded and am CEO of what is among the world's largest independent discretionary money management firms, serving tens of thousands of high net worth individuals and an impressive roster of institutions—major corporate and public pension plans and endowments and foundations—spanning the globe. I've written *Forbes's* "Portfolio Strategy" column for over 27 years, making me the fourth longest-running columnist in *Forbes's* long history. I write regular columns in Britain and Germany. And now, I've written eight books, five of which (including this one) were national bestsellers. Along the way, and without really aiming at it, I made the *Forbes* 400 list of richest Americans.

That's a lot for one lifetime and one professional career. But I'm here to tell you the prime cumulative lesson of my long career is when it comes to investing, there are only three questions that count. And my view on that hasn't changed since I first penned this book.

In reality, there really is only one question that counts. Or, at least, only one question that *really* counts. But I don't know how to express that one question in a way you can easily use for everyday investing decisions. If broken down into three subparts, I know how.

And what is that only question that counts? Finance theory is quite clear the only rational basis for placing a market bet is if you believe somehow, some way, you know something others don't know. The only question that counts is: What do you know that others don't?

Most people don't know anything others don't. Most folks don't think they're supposed to know something others don't. We'll see why. But saying you must know something others don't isn't at all novel. Pretty much everyone who took a basic college investment class was told this, although most people conveniently forget this truism.

Without answering the question—what do you know that others don't—investing with an aim to do as well or better than the market is futile. I'll say that another way. Markets are pretty efficient at pricing all currently known information into today's prices. There is nothing new about that statement. It's an established pillar of finance theory and has been repeatedly verified over the decades. If you make market decisions based on the same information others have (or have access to), you will overall fail relative to what the markets would have rendered you on their own without any decision making on your part. If you try to outguess where the market will go or what sectors will lead and lag or what stock to buy based on what you read in newspapers or chatter about with your friends and peers—it doesn't matter how smart or well trained you are—you will sometimes be right or lucky or both, but likely more often wrong or unlucky or both, and overall do worse than if you didn't make such bets at all.

I bet you hate hearing that. But I already told you I didn't know how to express that truism as a single question in a way useful to you. What I can do is show you how to know things other people don't know.

Polling for Perfect Truth

Why is knowing something others don't so important? Financial markets are “discounters” of widely known information—whatever information we commonly have access to has already been reflected in today's prices before we can articulate our knowledge of it. See it this way—compare markets to political elections that aren't discounters of known information.

You know professional pollsters can build a sample of about 1,000 people sufficiently representative of America's voters to foresee the immediate outcome of a national election within a predictable few percentage points. That technology is mature and time-tested. You're quite used to it. When a professional poll is done the night before the election, we know within maybe three to five percentage points how the election will end. It's all based on picking the participants in the poll to be representative of total votes.

Envision if someone could build a similar sample of all the world's investors. It would include every imaginable type in just the right proportions. Institutional and retail. Growth and value fans. Small and big cap. Foreign and domestic. Whatever imaginable. Suppose the pollsters polled the sample and suppose the consensus view was the market would rise next month—big time. Could it? No, because if everyone tended to agree the market would rise next month, anyone with any buying power would buy before then. The market might rise before next month, but only a fool would wait for next month to buy. Hence, next month there would be no subsequent buying power to drive the market higher. It could fall. It could stay flat. But it couldn't rise much. This is an oversimplification, but it's a useful illustration of how whatever we agree on has already been priced into the markets by the time we can articulate it, and, therefore, it can't occur. Since investors tend to be avid information seekers, the information they have access to has already been priced into the bets they've made.

Instead, it's surprise that moves markets. It's what happens next that few previously fathomed. Another piece of news consistent with what people previously expected can't move markets much further since investors already bet that way (to the extent they were able).

Said differently: You may be smarter, wiser or better trained than the next investor, but finance theory says that isn't enough. No matter how wise you think you are, you're a fool if you think being smarter or better trained is enough to beat others based on commonly available news and information. And the aim of this book is to show how to find those things you can know that others can't.

Investing by Knowing What Others Don't

Investing is a difficult, lifetime pursuit. Just knowing the questions isn't enough. You must know what the questions really mean and how to use them. And then you must actually put them to use diligently. Over and over again! The Three Questions don't constitute a craft or a simple "Three Steps to Riches" list. It isn't some *Investing Made Easy* to-do list for beating the market. If there were such a thing, I wouldn't be writing this book and you wouldn't be reading it. Instead, I'd put it in a single *Forbes* column and you would glean all you needed to know from it. From there, you would go off and promptly become unimaginably wealthy. No, it isn't *Investing Made Easy*. Instead, it's *Investing by Knowing What Others Don't*. In fact, that's why it's my subtitle.

If you can learn how to use the Three Questions, you can learn to start making better investing decisions. And that should give you an edge over your fellow investors.

Let's think about them. Your fellow investors.

Investing Isn't a Craft

You know some folks are idiots. You don't fear competing with them. But how will you compete with serious professionals who've had serious training, are seriously smart and have scads of experience? The good news is, in my observation, even most professionals don't have much better long-term results than your average amateur investor. How so? Because, despite many of them taking that class where they learn they must know something others don't, they forget or ignore it.

Inside the typical investor's mind is the false premise investing is a craft, like carpentry or doctoring. They don't treat investing like a scientific query session, which is what I'll teach you to do. Instead, consider how they approach it. Maybe they have a few favorite information sources—cable news, a few newspapers, some blogs and/or a newsletter from their guru du jour. Maybe they have software tracking price patterns. They may have specific rules they adhere to—momentum investing, buy the dips, buy on bad news. They look for clues or signals to buy or sell. They may wait for the S&P 500 and Nasdaq to correspondingly reach certain levels and then they buy or sell or just generally panic. They clock 90-day moving averages and monitor the VIX (the S&P 500 volatility index) or some other supposed predictive market indicator. (The VIX is a statistically provable worthless forecaster, by the way—but many people use it every day, applying a wasteful mythology losing more money than it makes.) They believe investing is a craft-like skill they can learn with enough diligence and effort. They believe those who acquire the best craft skills must be the better investors.

Investors categorize themselves and develop craft skills accordingly. The wannabe value investor develops a slightly different tool kit than the wannabe growth investor. Ditto for small-cap fans versus big-cap. Or foreign versus domestic. This works perfectly in carpentry. Anyone can learn basic carpentry, though some people are more naturally gifted than others. It works well for doctoring, if you're smart enough. It works for most sports, which are craft-based. Again, some folks are naturally better at some sports than others. Accounting, dentistry, lawyering, engineering and much more—all learnable crafts, though requiring varying degrees of time commitment and physical or mental prowess.

We know learning a craft is possible because there are countless people who perform craft-based functions after adequate training and apprenticeship (necessary to craft) in high quantities within acceptable and predictable bandwidths. The ability to train an accountant to do an audit in an acceptable manner is a perfect reflection of craftsmanship. But few folks beat the market,

amateur or professional. Darned few! So learning a craft obviously isn't enough to do it. Craftsmanship isn't sufficient to the task of beating markets.

Finance theory says it shouldn't be—craft won't help you—because you're supposed to know something others don't. That may excuse an amateur from failing to beat the market, but what about the pros? At a minimum, there are educational licensing requirements professionals must pass to legally advise clients. University students and doctoral candidates in investment finance spend years studying markets. They learn to analyze corporate balance sheets. They learn to calculate risk and expected return, but with widely known analytical tools like Sharpe ratios and R-squared and CAPM. And with all of this, they still can't beat the market any more often than those without a PhD.

Quite wisely, after years of study, some young wannabe professionals commit to apprenticeship by laboring under another established investor. At the knee of their chosen master, they generally learn a craft the same way a blacksmith apprenticed years ago. Some became generalists and others were specialists who made only weapons like swords and spears, while others made livery gear and plowshares. And today, you name the investing style, there are adherents, apostolic in their allegiance to the modality under which they apprenticed. Armed with degrees, certifications and apprenticeships, professional investors embark into the world, and still they overwhelmingly lag markets.

They most commonly start where entry is easiest, the way I did decades ago, rendering advice to individuals. These are your stockbrokers, financial planners and insurance and annuity salespeople. Some provide forecasts and prescriptions of their own, but those working for the big-name firms generally must kowtow to the firm's forecasts. This makes sense for the firm since it's the only way these larger institutions can maintain a semblance of control over their huge employee bases. Big firms hire a few folks with extremely prestigious schooling and extensive professional training who look and sound good for a role like *Chief Economist* or *Chief Market Strategist*—whose main responsibility is forecasting. Industry analysts then forecast in their own individual realms of experience and training. Clients of said illustrious firms, both private and institutional, get the benefit of not only their individual broker's schooling and experience, but also that of the learned, tenured bigwigs who think bigger and wig out well when needed.

So why, with all the knowledge, expertise and battle scars out there, do vastly more professional investors lag markets than beat them? These are smart people. A lot of them are very smart. Smarter than me for sure. You're probably pretty smart, too. Aren't you? You might be much smarter than me, too. But that won't make any difference on whether you can do better than me as an investor. Smarts and training are good—nothing wrong with them.

A PhD is good. But they aren't enough. And they aren't necessary. You must know something others don't and then—with that extra something—you can do better than people who are smarter than you are.

Because, Mr. Crafty, It's Not a Craft

The answer to improving your error rate isn't in perfecting a craft but in knowing something others don't.

More academic study won't do it. The most learned finance PhD knows free markets are at least pretty efficient (although they do disagree about exactly how efficient). Passing tests like the Series 6, 7, 65—or the CFA or a CIMA certification won't do it. They contain no information not known by millions of other folks and parroted in a distilled form throughout the media. More magazine subscriptions and migraines from pondering pontificating pundits won't do it. They're talking about what is known and therefore priced. And if they knew something everyone else didn't and told you via the media, instantly everyone else would know it and the new information probably would be priced almost instantly. Now, hereto, worthless! (I'll show you how to measure an exception to this later.)

You can study technical investing and buy software identifying price movement patterns. Won't do it! You can study fundamental investing and vow to buy only when P/Es are at a certain level and sell at yet another level. Won't do it! You can hire someone to do it for you who has the most designation letters after his or her name. But you won't beat the market over the long term if you treat investing like a craft.

Well, that's not quite true. If enough people try all this stuff, some very few will get there simply by dumb luck. In the same way, if enough folks line up to flip coins, you will find someone who gets 50 heads in a row; but who that is remains a fluke. And it likely isn't you. Nor is it the basis for investing or beating markets. And you can count on that.

If investing were a craft, some type of craft (or even some combination of crafts) would have demonstrated market superiority. Someone somewhere would have figured out the right combination to keep beating markets. The right formula, no matter how complicated!

If it were a craft in the very long term, there would be a clear sense a specific craft had generated an army of disciples who did better over the very longterm than conflicting approaches. But such evidence doesn't exist. If investing were a craft, the decades wouldn't have sired thousands of investment books teaching largely contradicting craft—with gurus, pundits and

seminars touting conflicting strategies. There would be a few differing strategies at most. There would be repeatability and consistency. Investing would be learnable like woodworking, masonry or medicine. Others could teach you. You could pass the skill on with efficacy. There wouldn't be so much failure. And you wouldn't have bought this book because anything I could say would be passé.

It's All Latin to Me—Starting to Think Like a Scientist

When I was a kid, if you wanted to be a scientist, they made you take Latin or Greek. I was a good student generally and took Latin, not because I wanted to be a scientist—I didn't—but because I couldn't figure out the benefit of my other options, Spanish or French. Since no one speaks Latin, I forgot almost everything immediately thereafter except the life lessons in which Latin abounds—like Caesar distinguishing himself by leading from the front of his troops, not the rear as most generals did (and do). It's maybe the most important single lesson of leadership. (One I write about more in my 2008 book, *The Ten Roads to Riches*.)

Another lesson: The word *science* derives from the Latin *scio*—to know, understand, to know how to do. Any scientist will tell you science isn't a craft; rather, it's a never-ending query session aimed at knowing. Scientists didn't wake up one day and decide to create an equation demonstrating the force exerted on all earthly objects. Instead, Newton first asked a simple question, like, "What the heck makes stuff fall down?" Galileo wasn't excommunicated for agreeing with Aristotle. He asked, "What if stars don't work like everyone says? Wouldn't that be nuts?"

Most of us would see the best scientists of all time, if we could meet them face to face, as maybe nuts. My friend Stephen Sillett, today's leading redwood scientist, changed the way scientists think about old-growth redwoods and trees in general by shooting arrows with fishing lines tied to them over the tops of 350-foot-tall giants, tying on a firmer line and free-climbing to the tops. He found life forms and structures up there no one ever knew existed. Dangling off those ropes 350 feet from terra firma is nuts. Nuts! But he asked the questions: What if there is stuff in the very tops of standing trees that isn't there when you cut them down? And if there is, would it tell you anything about the trees? In the process, he discovered much no one had ever known existed.

Why am I telling you this? Because most of what there is to know about investing doesn't exist yet and is subject to scientific inquiry and discovery. It isn't in a book and isn't finite. We just don't know it yet. We know more now

about how capital markets work than we did 50 years ago but little compared to what we can know in 10, 30 and 50 years. Contrary to what the pundits and professionals will have you believe, the study of capital markets is both an art and a science—one in which theories and formulas continually evolve and are added and adjusted. We are at the beginning of a process of inquiry and discovery, not the end. Its scientific aspect is very much in its infancy.

Scientific inquiry offers opportunities ahead as we steadily learn more about how markets work than we ever imagined we could know previously. What's more, anyone can learn things now that no one knows but in a few decades will be general knowledge. Building new knowledge of how capital markets work is everyone's job, whether you accept that or not. You're part of it, whether you know it or not. By knowingly embracing it, you can know things others don't—things finance professors don't know yet. You needn't be a finance professor or have any kind of background in finance to do it. To know things others don't, you just need to think like a scientist—think freshly and be curious and open.

As a scientist, you should approach investing not with a rule set but with an open, inquisitive mind. Like any good scientist, you must learn to ask questions. Your questions will help you develop hypotheses you can test for efficacy. In the course of your scientific inquiry, if you don't get good answers to your questions, it's better to be passive than make an actionable mistake. But merely asking questions won't, by itself, help you beat the markets. The questions must be the right ones leading to an action on which a bet can be made correctly.

So, what are the right questions?

The Only Three Questions That Count

First, we need a question helping us where we see wrongly. Then we need one helping us where we don't see at all. Third, we need one helping us sense reality when our eyes aren't at all appropriate as tools.

For our first question, we must identify those things we believe that are actually false. The question is: What do I believe that is actually false? Note what you believe is probably believed by most people. In Chapter 1, I'll cover this question in detail. But if you and I think something is true, then probably most people do. If most people do, we can predict how they will bet and we can learn to bet against these beliefs at times because the market will discount them and their false truths.

Suppose you believe factor X causes result Y. Probably most people do, and we can verify most people believe it. Then when you see X happen, you know

people will bet on Y happening next. But suppose you can prove in reality X doesn't cause Y at all. Now you know you can bet against Y happening while everyone else is betting it will happen. You can bet successfully against the crowd because you know something others don't. I'll show you how to do this.

Second question: What can I fathom that others find unfathomable? Here we need a process of inquiry allowing us to contemplate that which most people assume simply can't be contemplated at all. It's the essence of so-called out-of-the-box thinking. It's what made Edison and Einstein so successful but weird. They could think about how to think about the unthinkable. Think how unthinkable that is. Almost heretical! It's amazingly easier to do than most people assume, and it's a trainable skill. I'll show you how to do that in Chapter 2. Intuitively you know if no one knows what causes a particular result—let's call it result Q—and we can prove factor Z causes Q, then every time we see Z happen we can bet on Q happening more often than not because we know something others don't.

Finally, our third question: What the heck is my brain doing to mislead and misguide me now? To blindside me? Another way to ask this is: How can I out-think my brain, which normally doesn't let me think too well about markets? This is the realm of behavioral psychology. One thing you can come to know no one else can is how your individual brain works—what it does well in relation to markets and what it does badly and how to reprogram yourself to not use your brain in the ways it works worst for markets.

Few investors have spent any material time trying to understand how their own brains work. Most focus on craft, not internal deficiency. (*Note:* A craftsman wouldn't think about that at all.) You can learn how your brain works to hurt you, and when you do, you will know something almost unique since your brain is partly like other people's and partly yours uniquely. Chapter 3 covers this topic in very simple you-can-do-it lessons.

From there on, the rest of the book is simply about putting the Three Questions to work in various ways. We look at how to use the Three Questions to think about the overall market, different parts of the market and even individual stocks. We'll apply them to interest rates and currencies. We look at lots of things I've figured out over the years using the Three Questions. We also address areas I haven't figured out because there is still a lot of potential figuring to do, and you may be the person who figures these things out in the years ahead. We won't be able to cover everything, everywhere—nor is there a need for that.

I will make a lot of statements of fact you won't have heard before or think sound simply wrong, nuts and crazy. I've come to those conclusions using the Three Questions, and I'll show you how in each case. You can still disagree with me. That's ok. But if you learn how to use the Three Questions and you want to explore any area, including these, and have the time, you can do it on

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your own later. Forever! You can use the Three Questions to show me where I was wrong and messed up. I'd be delighted, and you should feel free to write me to show me evidence, using the Three Questions, where I'm wrong.

There are endless opportunities to discover new things in terms of what we don't know. You don't need to know everything. You need to know some things others don't know. If you learn to apply the Three Questions yourself, you'll be empowered to know things others don't for the rest of your life.

An additional note for those reading the second edition: Where I could, I updated graphs and numbers with the most recently available data. I left a few charts alone because they were fine examples of the point I made. I also replaced a few because in the intervening years, I've found a better way to make the same point. I also added commentary and a few new graphs in a few places.

Also, there's that old saying, "If I had more time, I'd write you a shorter letter." In reviewing this book to update it, I discovered many places where I could make the book more readable for you (and therefore, a better tool), not sacrifice any concepts and simply make my commentary briefer. Or maybe, some examples and anecdotes seemed particularly relevant in 2006 but much less so now.

What amazed me most in reading this was how much the basic framework of the Three Questions hasn't changed. And that's the idea. Over time, you get more knowledge, more data. Something that once worked doesn't anymore. Something that didn't work at all becomes more relevant. The world moves and changes and is dynamic, but the basic process of a disciplined scientific method shouldn't change. Which is why these are the Three Questions that *still* count.

Ken Fisher

Woodside, California

ACKNOWLEDGMENTS

Initially, when approached about doing a second edition of this book, I thought, “Why?” I like old investment books. You can learn tons from them—they tell you lots about what impacted people at a point in time, how they thought and why that’s evolved. Then, too, I felt this book sufficiently evergreen that readers could still get something material out of the original 2007 version.

I still believe that, but there’s a ton of data and graphs in this book. And what was interesting in updating them was how well they held up overall. After all, the past five years were far from dull. (Then again, I defy anyone to find any five-year span in capital markets that *was* dull. People tend to see the now and recent past as radically new and different—a common error I address in my 2011 book *Markets Never Forget*.) As I write in late 2011, we are now nearly three years from the bottom of a historically big bear market. And yet, the Three Questions are as valid as ever, as the updated graphs, data and commentary will show.

Once again, I pulled Lara Hoffmans from her other duties to assist me in doing first-round edits and overseeing the big task of updating data and graphs. Lara is managing editor of my firm’s webzine MarketMinder and oversees a team responsible for creating client-facing content. Filling in for her while she was otherwise occupied on this task was her team of terrific writers: Todd Bliman, Amanda Williams, Elisabeth Dellinger and Naj Srinivas. Backing up Lara in other unaccountable ways are the other members of her team, Fab Ornani (whose web savvy I appreciate immeasurably), Molly Lienesch, Collin Smith, Jake Gamble, Evelyn Chea, Kris Bullard,

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My team at Wiley also deserves special thanks, particularly Laura Walsh who is, as always, very professional and patient.

Updating a book is nowhere near as time consuming as writing a new one, particularly when I'm fortunate to have as talented a supporting cast as anyone in the publishing world. Assisting me as always in the business of my firm, whether I'm writing a book or not, are co-presidents Steve Triplett and Damian Ornani. Assisting in the management of my firm's portfolios are Vice Chairmen Jeff Silk and Andrew Teufel, along with William Glaser and Aaron Anderson. This group forms the smartest group of gentlemen I've ever had the pleasure of working with.

Though not instrumental in this second edition, the first edition would not be what it had been (and not be worthy of an update) without Jennifer Chou, Elizabeth Anathan, Jill Hitchcock, Greg Miramontes, David Watts, Pierson Clair, Thomas Grüner and Justin Arbuckle. Meir Statman (the Glen Klimek Professor of Finance at Santa Clara University) and Grover Wickersham also provided welcomed feedback on the first edition. Some I agreed with, some I didn't. But either way, the book was and is better for their input. And I must also thank David Pugh from Wiley, who edited this book the first time, and Jeff Herman, my agent, who first suggested seven years ago that I ought to think about doing another book.

And, finally, I must thank my wife, Sherrilyn—whose immense patience and love through the years have made our life's work possible.

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QUESTION ONE: WHAT DO YOU BELIEVE THAT IS ACTUALLY FALSE?

If You Knew It Was Wrong, You Wouldn't Believe It

It's safe to assume if you knew something was wrong, you wouldn't believe it true in the first place. But in a world where so much of industry-applied craft has morphed into long-held mythologies, much of what everyone believes is false. This isn't any different from long ago when humanity believed the world was flat.

You needn't beat yourself up if you fall prey to false mythologies. Pretty much everyone has and does. Once you accept that, you can begin gaming everyone else with greater success.

If sorting false mythology from fact were trivial, there wouldn't be so many false truths. While this isn't trivial, it isn't impossible either. One inherent difficulty is this approach requires being skeptical about all your prior beliefs—something most humans dislike. In fact, most humans hate self-questioning and prefer spending time convincing themselves (and others) their beliefs are right. Effectively, you can't trust any conclusion you thought you knew.

To think through false mythologies, we must first ask: Why do so many people believe things that are false? And why do false truths persist—getting passed down the decades as if they were fact? It comes back to the same point: People persist in believing things that are wrong because, individually, people rarely investigate their own beliefs, particularly when what they believe makes sense intuitively—even more so when those around them agree with them.

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As a society, we are often encouraged to challenge someone else's views, as in, "I know those @&%\$#! (insert either Republicans or Democrats as you choose) are full of phony views!" But we aren't trained to challenge ourselves or to question the basic nature of the universe the way an Einstein, Edison or Newton would. Our instinct is to accept wisdom passed to us by former generations or smarter people or both. These beliefs don't require investigation because we believe certain truths are beyond our ability to challenge. Often in life, that is right. I mean, if "they" can't figure it out, how could I?

Medicine is a good example. We are correctly conditioned to go to the doctor, describe symptoms, hear prognosis and accept a prescription. Generally, that is good conditioning because medicine is an example of science and craft operating largely in parallel harmony—not perfectly because there are certainly plenty of myths among doctors—but generally because over time science modifies the craft and the craft improves. Because there are so many life examples where our conditioning serves us well, we're blind to the few areas, like capital markets, where it doesn't.

There are myriad beliefs you're likely to share with your fellow investors. These beliefs have been built into decades of literature and are among the first things people learn when they start investing and have been accepted by the biggest names around us. Who are *you* to question and challenge them?

Exactly the right person!

For example, investors categorically believe when the stock market has a high price-to-earnings ratio (P/E), it's riskier and has less upside than when it has a low P/E. Think about it casually, and it probably makes sense. A high P/E means a stock (or even the whole market) price is high—way high—compared to earnings. Get too far out on that scale, and it would seem a high P/E means a stock is vastly overpriced and likely to start falling. This belief is so widely held by so many people, seems so logical and has been a basic tenet of investing for so long that if you start proposing to your friends it's false, you will meet with overwhelming rejection, ridicule and perhaps suggestions you're morally deficient somehow.

Yet I proved statistically more than 15 years ago the P/E, no matter its level, by itself tells you nothing about market risk or return. Statistics aside, if you delve heavily into theory (as we do later), you will also learn the P/E shouldn't tell you anything about risk or return anyway. But tell that to people, including the overwhelming bulk of people who have been trained and should know better, and they will think you're crazy—a real whack-job.

The cool part comes after we accept the truth that P/Es tell you nothing about future returns by themselves—when people are freaking out, fearfully fretting over the market P/E being too high, we can bet against the market falling.

While that won't always work because something else can come along and knock the market down (we cover how to better see that later), it will work much more often than not. In the same way, if the market's P/E is low and we can sense people are optimistic because of it, we can bet against them also. The key is understanding the truth instead of the mythology. This is basic to the scientific approach.

Many false mythologies—like the P/E one—are accepted widely by the best and brightest minds and passed to the investing public through all forms of media. They don't inspire questioning from you, me or anyone. We have faith in them, like Catholics do in the Trinity and environmentalists in global warming, and they require no further proof. Holy! Sacred! No one questions these beliefs. No one offers dissenting analysis. And if you do, you're a heathen. And because there is no dissenting opinion, society feels no need to see proof of these alleged investing truisms with statistically valid data. And mythology continues.

How can it be so few demand hard evidence to support generally accepted investing wisdom? Why do investment decisions not get the scrutiny that car mechanics do? We should be at least as skeptical, if not more so, of the financial industry's pronouncements. To change the success (or lack thereof) you've had so far with investing, be skeptical. Be a cynic. Be the one to point out the emperor wears no clothes. Look around and assess what you and your fellow investors are accepting as truth. But the most important person to be skeptical of is yourself.

Long ago as I read or listened to media, I'd note things I believed were false and run off to do independent checking to prove I was right. (People love to prove they're right.) I'd gather data and do statistical analysis to prove they were wrong and I was right; and I could prove I was right to my satisfaction pretty often. (It's amazing how often people can prove they're right to their own satisfaction—the plaintiff, judge, jury and executioner all in one.) But later I realized I was doing the wrong thing. What I should have been doing was looking in the media for assertions I believed were *true* and then checking to see if they weren't really false.

Why?

If I believe the assertion is true, then probably so do many others, if not the overwhelming bulk of investors. Maybe everyone. And if we're all wrong, there's real power there. If I can prove I'm wrong and most everyone else is also wrong, then I've got some useful information. I can bet against everyone knowingly. I've got one provable form of knowing something others don't.

Suppose I believe factor X causes result Y. If I believe it, probably most other folks do, too. But if I'm wrong, most everyone else is wrong. When X

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happens, people will move to bet on Y happening. Suppose I can learn X doesn't cause Y. That means something else is causing Y. That means after X happens, Y happens sometimes, but it's purely random to X's existence. Now when X happens, people will still move to bet on Y happening, but I can bet against Y happening, and I'll be right more often than I'm wrong. (If I can figure out what actually causes Y, I can take a big step further, but we don't cover that step until Chapter 2 and Question Two.)

With our P/E notion, we can see one such perfect example. Say the market's P/E goes up—a lot. Normal investors notice and conclude risk has risen and future return is lower and bet against the market doing well. Sometimes stocks won't do well, but more often than not stocks will be just peachy because the P/E by itself tells you nothing about market risk and direction.

When I see a high-P/E market and fear of it, I can bet against the market falling. Sometimes, like 2000, it won't work. But more often, like 1996, 1997, 1998, 1999, 2003 and 2009, it will. I don't expect you to believe the P/E thing right now. Right now, I expect you to believe the traditional mythology about P/Es and not even be very interested in challenging it. (We get to that later in detail.) For now, I just want you to accept in your bones if you can learn an accepted mythology is actually false, you can bet against it and win more often than you lose.

Using Question One

A good way to think about successful investing is it's two-thirds not making mistakes and one-third doing something right. Hippocrates is frequently credited with the phrase, "First, do no harm," and it's a good investment principle.

To first do no harm, you must think about what you believe and ask yourself whether it's correct and factually accurate. Go crazy. Question everything you think you know. Most people hate doing this, which gives you a real advantage over them. As stated in this chapter's title, this is the first question: What do you believe that is actually false?

Asking Question One helps only if you can be honest with yourself. Many people, particularly in investing, are constitutionally incapable of contemplating they're ever wrong. They will tell you they do well and likely hoodwink themselves into believing it—but they don't. And they never subject themselves to reliable independent analysis. You must accept that you and the pundits and professionals from whom you glean information can be and probably are wrong about many basic beliefs. Me too!

Have you ever presented such a question to yourself about capital markets? Asking yourself if what you believe is actually wrong requires introspection.

As humans, we're hardwired to be overconfident. This is hardly a new development. Behaviorists will tell you our Stone Age ancestors had to be overconfident to hunt giant beasts each day armed merely with stone-tipped sticks. If they practiced introspection and came to the rational conclusion that tossing a flint-tipped branch at a buffalo was utter lunacy, they, their families and their communities would have starved. In fact, overconfidence—the belief you can do something successfully when rationality would argue otherwise—is basic to human success in most fields and necessary to our successful evolution as a species. However, it hurts tremendously when it comes to capital markets. (More on this in Chapter 3.)

Just so, investors are loath to question generally accepted knowledge. If we started doing so, we might soon realize the market exists solely to humiliate us as much as it can for as long as it can for as many dollars as it can. I refer to the market by its proper name, “The Great Humiliator” (TGH for short). I've come to accept my goal is to interact with TGH without getting humiliated too much.

TGH is an equal-opportunity humiliator. It doesn't care if you're rich or poor, black or white, tall or fat, male or female, amateur or an Olympian. It wants to humiliate everyone. It wants to humiliate me and you, too. To be frank, I think it wants to humiliate me more than it does you. You're fun to humiliate, but if you're fun, I'm more fun. I'm (probably) a more public figure than you and therefore a bigger TGH target. Think how much TGH would love to humiliate Warren Buffett. The bigger you are, the more TGH wants you. But in reality, TGH wants to get everyone and does a pretty good job at getting them all eventually. Can't be sated!

How do you, personally, give TGH the most fun? By making the most bets you can based on the same information everyone else has. How do you spoil the fun for TGH? By restricting bets you make to things you think you actually know that others don't.

Practice using Question One the same way I should have—by scanning the media for things asserted you believe. Make a list of them. They can be about single stocks, whole markets, currencies or anything. Make a list of anything influencing your decisions, whether on single stocks, asset allocation, anything.

Make note of decisions you've made not supported by data or any other information. Underneath there somewhere is something you believe—might be right or might be wrong. Be particularly wary of making a decision simply because of something you know others agree with. Highlight, underline and asterisk decisions prompted or based on common investor catechism. Ask what evidence you figured out for yourself supporting these beliefs. Is there any? For most investors, there isn't much.

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Common Myths You Believe In, Too

For example, you may hold a stock with a high P/E ratio. You believe a high P/E signals an overvalued stock, so you decide to dump the stock and buy one with a lower P/E. It's a fairly rational decision you may have made countless times before, and one many people would agree is rational.

But are high P/Es bad for single stocks or the market? Have you personally checked the data? If you have asked the question, where did you find the answer? Did you look at the numbers, or did you rest easy because conventional wisdom or some big-name guru endorsed your belief?

Take another scenario. You hold a stock that does well in rising markets but badly in falling ones—a typical, highly volatile stock. However, you know the US federal government is running a growing budget deficit—not only a deficit, but a historically high deficit and one that “can't go on forever.” You know federal budget deficits left unchecked are “bad for the economy” and, in turn, “bad for the stock market.” All that debt caused by the deficit must be paid back by future generations, and the market will reflect that sooner or later, right? The burden of the deficit has long-term rippling implications, holding down growth and earnings. The deficit has grown to such a size you know a bear market looms eventually. In that environment, your highly volatile stock would do badly, and so you sell.

But how do you know budget deficit peaks are followed by poor stock performance? Is it true? Most folks won't ask the question or check history. If they did, they would be sanguine about stocks rather than fearful. Historically, big budget deficits in America and around the world have been followed by materially above-average stock market returns. Don't fear deficits—it is big budget surpluses that have been soon followed by bad markets.

That doesn't make intuitive sense to you. Deficits must be bad and surpluses good, right? After all, the word *deficit* has the same Latin root as *deficient*—and that must be bad. Most folks won't challenge their own beliefs on these kinds of subjects. The notion that big deficits are bad is overwhelming. Few beliefs have as much broad acceptance from professionals, nonprofessionals and folks from both ends of the political spectrum alike. A good way to get the proletariat on your side at a political rally is to vow to lower budget deficits. It's a crowd pleaser.

Here's a baker's dozen of some general beliefs you probably hold, or at least most people do. We've already covered two:

1. High-P/E markets are riskier than low P/E markets.
2. Big government budget deficits are bad.

Let's think about some more:

3. A weak US dollar is bad for stocks.
4. Rising interest rates are bad for stocks. Falling rates are good.
5. A tax cut causes more debt, which is bad for stocks.
6. Higher oil prices are bad for stocks and the economy.
7. Stocks do well when the economy does well.
8. Stock markets do better in countries with faster-growing economies than slower ones.
9. Small stocks do better than big ones.
10. Stocks of firms that grow more do better than those that don't.
11. Cheaper stocks do better than less cheap stocks.
12. Big trade deficits are bad for stock markets.
13. America has way too much debt.

They're all familiar to you. This is just a short list—a subset of a much bigger list—of views most folks believe that are partly or wholly false. For example, the notion America is way too heavily in debt is backward. As I say that, you may be shriekingly dismissive, or maybe the statement makes you mad. It challenges your belief set. If the statement makes you either dismissive or mad, you really need the rest of this book. The most standard reaction to someone stating your belief is wrong is to be dismissive and, if further confronted, to get mad.

Anger is a very good warning sign because anger is always, *always* about fear. Angry people usually don't know they're fearful. If you're dismissive or angry, you must question yourself to see how and why you concluded your belief was right in the first place. Was it mythology? Was it basic bias? Are you right or not? Sometimes the items in this list and others beyond it are part true and part false, depending on surrounding circumstances. (We look at all of these and more later on.) But the most obvious question is: Why would you believe any of these statements?

I'd say you believe myths mostly because of two facts: (1) They make common sense, and you aren't typically prone to challenge your own common sense. (2) People around you tend to agree these things are true, and you aren't prone to challenge widely held views.

Let's Prove You're Either Right or Wrong (or Really, Really Wrong)

As you attempt to debunk investor mythology using Question One, you will find three basic results. Either you were right all along (which may happen less frequently than you might have hoped), or you were wrong, or you were

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really, really wrong. Any of these outcomes is ok because it tells you how to bet better, later.

Let's examine more closely the instances when you're wrong. You and most of your fellow investors (amateur and professional) often believe something is causal—X happens because of Y—but in reality, there is no correlation at all. By now you're willing to embrace that can happen, or you would have stopped reading this book. The example we debunk is the aforementioned commonly held belief high-P/E stock markets are risky with subsequent below-average returns. As previously mentioned, it turns out high-P/E markets aren't predictive of poor returns—not even remotely. In fact, historically, they've led to some pretty good returns. What's more, low-P/E markets aren't predictive of good returns either.

The Mythological Correlation

Forgetting for now why the P/E myth is so easy to buy into, we know people overwhelmingly do believe high-P/E markets predict below-average returns and above-average risk.

But if it were true, you could show some form of high statistical correlation between the claimed cause and result. A statistician will say you can have high correlation between two things out of quirky luck with no causation. But the same statistician will tell you that you can't have causation without high correlation (unless you run into scientific nonlinearity, which doesn't happen in capital markets to my knowledge—but you could check on your own with the Three Questions when you're finished with this book). When a myth is widely accepted, you will find low correlations coupled with a great societal effort to demonstrate, accept and have faith in correlations that don't really exist.

Investors will root out evidence supporting their favorite myths and create justifications for their belief—factor X causes result Y—while ignoring a mountain of evidence that X doesn't cause Y at all. Now let's suppose everyone is of good intent. Still, even with the best of intentions, it's easy for people to latch onto evidence confirming their prior biases and ignore evidence contradicting their views. Looking for evidence to support your pet theory is human. Accepting evidence to the contrary is no fun at all. This is done in varying ways. One way is to look at a particular time period verifying the false belief and ignore other periods. Another is to redefine either X or Y in a bizarre way so the statistics seemingly prove the point and then generalize afterward about X and Y without the bizarre definitions. Discoveries of data supporting popular myths become popular discoveries.