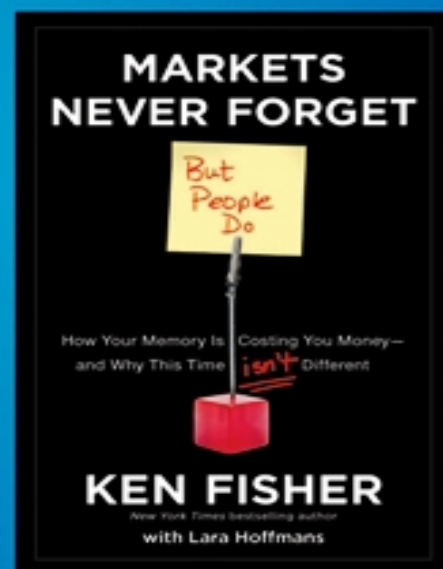
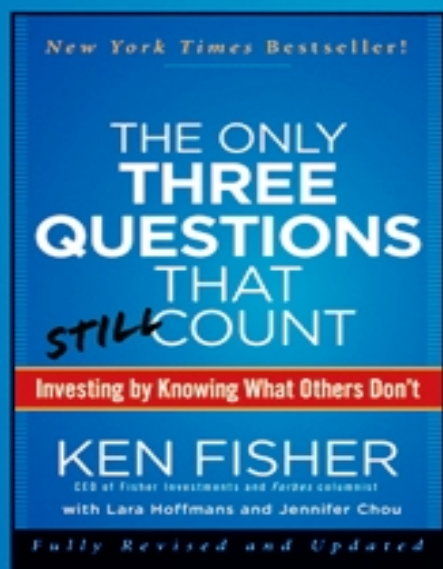
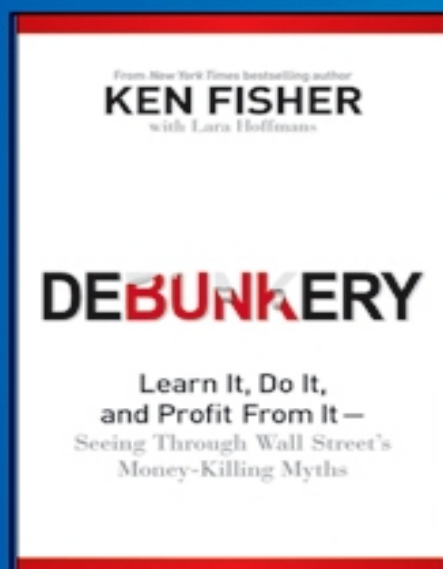


THE
KEN FISHER
CLASSICS
COLLECTION



KEN FISHER
with Lara Hoffmans

NEW FOREWORD BY **KEN FISHER**

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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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The Only Three Questions That Still Count

**Investing by Knowing
What Others Don't**
Fully Revised and Updated

KEN FISHER
WITH LARA HOFFMANS
AND JENNIFER CHOU



WILEY

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PREFACE

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 outthink 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 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, Thomas McEnany,

Cianne McGeough, Thomas Perez and Leila Amiri, all under the guidance of Group Vice President David Eckerly.

Doing the heavy-lifting grunt work of running down all the data and updating graphs were Danielle Lynch and Jessica Wolfe. Both have contributed to books I've written in the past, and I appreciate their diligence, attention to detail and great patience with our requests to check, check and check again the data. Matt Schrader, head of my firm's Research Analytics and Production team does a great job, too, of ensuring data for this book (and for my firm) are as accurate as can be.

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Chapter 1

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?