

How to Profit by Avoiding the Investing Mistakes Everyone Else Makes



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WITH LARA HOFFMANS

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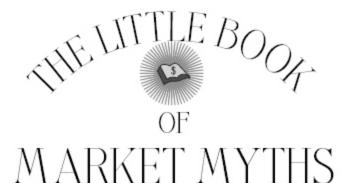
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How to Profit by Avoiding the Investing Mistakes Everyone Else Makes

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Preface

Questioning yourself is hard.

One of the hardest things we do (or rather, don't do). Folks don't like questioning themselves. If we question, we might discover we're wrong, causing humiliation and pain. Humans evolved over many millennia to take any number of extraordinary and often irrational steps to avoid even the risk of humiliation and pain.

Those instincts likely helped our long-distant ancestors avoid being mauled by wild beasts and starving through long winters. But these deeply imprinted instincts often are exactly wrong when it comes to more modern problems like frequently counterintuitive capital markets.

I often say investing success is two-thirds avoiding mistakes, one-third doing something right. If you can just avoid mistakes, you can lower your error rate. That alone should improve your results. If you can avoid mistakes *and* do something right on occasion, you likely do better than most everyone. Better than most professionals!

Maybe you think avoiding mistakes is easy. Just don't make mistakes! Who sets out to make them, anyway? But investors don't make mistakes because they know they're mistakes. They make them because they think they're making smart decisions. Decisions they've made plenty of times and have seen other smart people make. They think they're the right decisions because they don't question.

After all, what sense does it make to question something that "everyone knows"? Or something that's common sense? Or something you learned from someone supposedly smarter than you?

Waste of time, right?

No! You should always question *everything* you think you know. Not once, but every time you make an investing decision. It's not hard. Well, functionally it's not hard, though emotionally and instinctually, it might be. What's the worst that can happen? You discover you were right all along, which is fun. No harm done. No humiliation!

Or . . . you discover you were wrong. And not just you, but the vast swaths of humanity who believe a false truth—just as you did! You've uncovered a mythology. And discovering something you previously thought to be true is actually myth saves you from making a potentially costly mistake (or making it again). That's not humiliating, that's beautiful. And potentially profitable.

The good news is, once you start questioning, it gets easier. You may think it impossible to do. After all, if it were easy, wouldn't everyone do it? (Answer: No. Most people prefer the easy route of never questioning and never being humiliated.) But you can question anything and everything—and should. Start with those things you read in the paper or hear on TV and nod along with. If you're nodding, you've found a truth you've probably never investigated much, if at all.

Like the near-universal belief high unemployment is economically bad and a stock market killer. I know of no one who says the reverse—that high unemployment doesn't cause future economic doom. Yet, as I show in Chapter 12, unemployment is provably a late, lagging indicator and not indicative of future economic or market direction. And amazingly, recessions start when unemployment is at or near cyclical lows, not the reverse. The data prove that, and fundamentally it makes sense, once you start thinking how a CEO would (as I explain in the book). This is a myth I disprove using pretty easy-to-get data from public sources. Data that's universally available and easy to compile! But few question this myth, so it endures.

This book covers some of the most widely believed market and economic myths—ones that routinely cause folks to see the world wrongly, leading to investing errors. Like America has "too much" debt, age should dictate asset allocation, high dividend stocks can produce reliable retirement income, stop-losses actually stop losses and more. Many I've written about before in various books, but here I collect what I view as the most egregious myths and expand on them or use a different angle or updated data.

Then, too, I've written about many of these myths before simply because they *are* so widely and rigidly and wrongly believed. My guess is writing about them here again won't convince many (or even most) the mythology is wrong. They'll prefer the easy route and the mythology. And that's ok. Because you may prefer the truth—which gives you an edge—a way to avoid making investment decisions based not on sound analysis and/or fundamental theory, but on a myth everyone believes just because.

Each chapter in the book is dedicated to one myth. Jump around! Read them all or just those that interest you. Either way, I hope the book helps you improve your investing results by helping you see the world a bit clearer. And I hope the examples included here inspire you to do some sleuthing on your own so you can uncover still more market mythology.

You'll quickly see a few common characteristics throughout the chapters. A how-to manual to myth debunking, if you will. The tactics I use over and over to debunk these myths include:

Just asking if something is true. The first, most basic step. If you can't do this, you can't move to later steps.

Being counterintuitive. If "everyone knows" something, ask if the reverse might be true.

Checking history. Maybe everyone says XYZ just happened, and that's bad. Or it would be so much better

if ABC happened. Maybe that's true, maybe not. You can check history to see if XYZ reliably led to bad or ABC to good. Ample free historical data exist for you to do this! Running some simple correlations. If everyone believes X causes Y, you can check if it always does, sometimes does or never does.

Scaling. If some number seems impossibly scary and large, put it in proper context. It may bring that fear down to size.

Thinking globally. Folks often presume the US is an island. It's not—the US is heavily impacted by what happens outside its borders. And investors the world over tend to have similar fears, motivations, etc.

There are plenty of myths investors fall prey to—I couldn't possibly cover them all here. But if you can get in your bones the beauty and power of questioning, over time, you should be fooled less by harmful myth and get better long-term results. So here we go.

Chapter One

Bonds Are Safer Than Stocks

"Everyone knows bonds are safer than stocks."

You've heard that said so often, maybe it doesn't seem worth investigating. With 2008 still fresh in most investors' minds, it may seem sacrilegious to even question this. (Another odd behavioral quirk: Stocks were up huge in 2009 and 2010, flattish in 2011, and up again in 2012 as I write. Yet the bad returns five years back loom so much larger in our brains than the four subsequent years of overall big positive returns.)

But those beliefs that are so widely, broadly, universally held are often those that end up being utterly wrong—even backward.

Go ahead. Ask, "Are they?"

And initially, it may seem intuitive that plodding bonds are safer than stocks with their inherent wild wiggles. But I say, whether bonds are safer or not can depend on what you mean by "safe."

There's no technical definition—there's huge room for interpretation. For example, one person might think "safe" means a low level of expected shorter-term volatility. No wiggles! Another person might think "safe" means an increased likelihood he achieves long-term goals, which may require a higher level of shorter-term volatility.

Bonds Are Volatile, Too

People often make the error of thinking bonds aren't volatile. Not so. Bonds have price volatility, too. And their prices move in inverse relationship to interest rates. When interest rates rise, prices of currently issued bonds fall, and vice versa. So from year to year, as interest rates for varying categories of bonds move up and down, their prices move down and up. Some categories of bonds are more volatile than others—but in any given year, bonds can have negative returns—even US Treasurys.

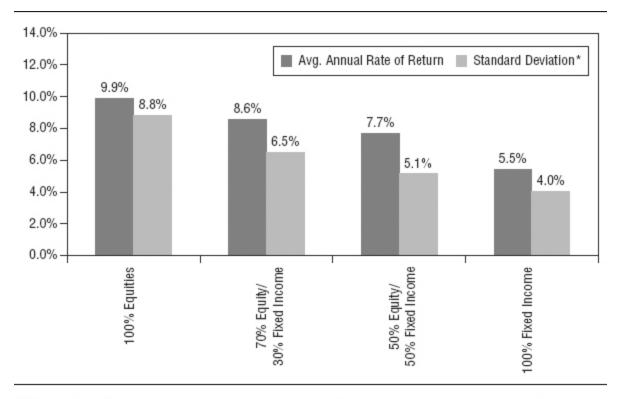
But overall, as a broader category, bonds typically aren't as volatile as stocks—over shorter time periods.

That's an important caveat. *Over shorter time periods* like a year or even five, bonds are less volatile. They have lower expected returns, too. But if your exclusive goal is avoiding much volatility, and you don't care about superior long-term returns, that may not bother you.

<u>Exhibit 1.1</u> shows average annual returns and standard deviation (a common measure of volatility) over five-year rolling periods. It's broken into a variety of allocations, including 100% stocks, 70% stocks/30% fixed income, 50%/50% and 100% fixed income.

Exhibit 1.1 Five-Year Time Horizon—Volatility

Source: Global Financial Data, Inc., as of 06/22/2012. US 10-Year Government Bond Index, S&P 500 Total Return Index, average rate of return for rolling 5-year periods from 12/31/25 through 12/31/11.



*Standard deviation represents the degree of fluctuations in historical returns. This risk measure is applied to five-year annualized rolling returns in the chart.

Returns were superior for 100% stocks. And, not surprising, average standard deviation was higher for 100% stocks than for any allocation with fixed income—meaning stocks were more volatile on average. The more fixed income in the allocation over rolling five-year periods, the lower the average standard deviation.

So far, I haven't said anything that surprises you. *Everyone knows* stocks are more volatile than bonds.

Stocks Are Less Volatile Than Bonds?

But hang on—if you increase your observation period, something happens. <u>Exhibit 1.2</u> shows the same thing as <u>Exhibit 1.1</u>, but over rolling 20-year periods. Standard