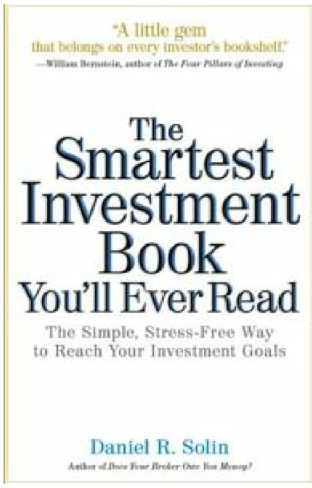

Book The Smartest Investment Book You'll Ever Read

The Simple, Stress-Free Way to Reach Your Investment Goals

Daniel R. Solin
Perigee, 2006
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Recommendation

Daniel R. Solin's handy book demonstrates why trading stocks actively is a great idea for your broker or financial advisor, but could be a very bad idea for you and your hard-earned savings. Solin's investment method, while not presented as a fresh invention, is simple: He encourages you to set up a very low-cost account with a reputable company, allocate your assets in a mix of stock and bond indexes that represent the entire market, and regularly rebalance your portfolio to bring it back in line with your desired asset allocation. Solin's virtue is his energetic, sometimes entertaining writing style, as displayed in 44 snappy chapters that avoid financial theory almost completely. He focuses on dollars and cents, and how best to keep them in your own pocket. *BooksInShort* recommends this smart guide as a primer for beginners or financially unsophisticated investors.

Take-Aways

- Some money managers engage in "Hyperactive Investing," carelessly using your money to try to select winning stocks and outperform the market.
- However, almost no one can beat market returns in the long run.
- Hyperactive investing benefits your financial advisors more than you.
- Fees paid to brokers and financial advisors lower your returns.
- Hyperactive trading may be entertaining, but it is a very risky casino game.
- Instead, invest your money in a low-cost market portfolio of diversified stock and bond market indexes. That is where the "smart money" goes to grow.
- Index funds yield an average weighted return on all the stocks or bonds in a broad index.
- Index funds allow you to choose a preferred level of risk. Deciding how to allocate assets is the most important decision a "Smart Investor" makes.
- Firms such as Fidelity and Vanguard facilitate "Smart Investing" in index funds.
- Rebalancing your "Smart Portfolio" takes 45 minutes every six months.

Summary

"Hyperactive" or "Smart" Investing?

Sadly, millions of people believe that their brokers or financial advisors are privy to some secret that enables them to outperform the market, despite a large number of studies that indicate that it just isn't so. Some financial advisors cleverly market their superior performance over a carefully selected time frame to get you to invest with them. They want to trade your money actively to generate fees for themselves. If you happen to make money as their client, they will entice you to invest more. However, if you lose money, they will point to the small print that says past performance does not guarantee similar future returns. Either way, they still take their fees.

Their talk is powerful, but their performance is usually unspectacular.

> "There are 100 million individual investors in the United States. They hold $8 trillion of stocks. More than $7.5 trillion of this money is invested in the wrong way."

These "hyperactive" traders generally use either "market timing," predicting crests and troughs in stock prices, or "stock picking," choosing undervalued stocks in anticipation that their performance will improve. However, money managers who engage in hyperactive investing cannot consistently beat or time the market. The more expensive, exclusive products they sell are not superior to low-cost index funds, that is, funds that yield an average weighted return on all the stocks or bonds contained in a broad index. If you arrange your investments to get market returns, you will perform better than 95% of portfolios managed by professional money managers. That's "Smart Investing," and it works, based on certifiable data and market studies.

> "There is little independent...scientifically valid evidence that anyone can successfully engage in either market timing or stock picking consistently over the long term...All the evidence concludes that the opposite is true."

Using the Smart Investing approach, you can achieve low-cost market returns with 90 minutes of work every year. For example, by altering the mix of three Vanguard managed index funds, you can create a low-risk, medium-low-risk, medium-high-risk or high-risk portfolio. The three funds are Vanguard's Total Stock Market Index Fund (VTSMX), Total International Stock Index Fund (VGTSX) and Total Bond Market Index Fund (VBMFX).

> "Smart investors do not engage in stock picking. They know that it is a fool's errand. Smart investors are not fools."

If you use Smart Investing, you won't need a broker or an advisor, you won't have to worry about picking hot stocks and you will have almost no stress. Does this mean that you'll never need a financial advisor? No. If you have a portfolio worth a million dollars or more, professional advisors can provide more value than they cost you. They can help you think through tax and estate issues that the average person does not face on the same scale.

How Most Brokers Make You into a Hyperactive Trader

Managed funds are all trying to beat some "benchmark index." If they can't meet their benchmarks, they do not provide any value to their investors. More than 90% of managed funds fail to beat or even equal their benchmarks over the long term. This means that on average Smart Investors who put their money in "passive" index funds will enjoy higher returns than "Hyperactive Investors." Hyperactive money managers enjoy the higher fees and trading costs paid by their clients – usually around 1.5% per annum versus 0.35% for index funds. But Hyperactive Investors lose out. The reports they get state what the fund earned before costs and fees; they actually receive less. Why isn't this truth more obvious? Many fund managers are very skilled at concealing information. The financial media where they advertise support their efforts. Financial magazines fill their pages with new stocks, picks and sensational returns. If they printed only the truth about returns and market indexes, they would have a hard time selling advertising, let alone writing new articles.

> "Only 46% of the actively managed funds beat the index during the first five-year period, and only a pathetic 8% beat the index during the second five-year period."

Of course, investors who pursue the "Hyperactive Strategy" have to take their share of the blame. Some folks enjoy gambling, and treat buying and selling stocks like a high-stakes casino game. Others believe in their own abilities far too much and only learn after the market beats them to their financial knees. Don't be one of them. When you hear claims about doubling your money or sure bets in the market, just walk away. You worked too hard for your money to let someone else take it from you.

> "Go ahead, ask your broker what the standard deviation of your portfolio is. If he or she can compute it for you, right there in the office, without asking for help, I will be stunned."

But, you might ask, isn't paying close attention and constantly attending to your investments, as you would a garden of exotic flowers, simply the responsible thing to do? No. Constant pruning and transplanting harms those flowers just as constant trading does your investments. However, your broker or advisor will be grateful whether you earn or lose money. The broker wins when you trade – not when you earn (or lose) money. Analysis of prominent brokerages has shown that those who advocated a hyperactive style of trading not only failed to give market-beating advice, they were the most likely to become entangled in legal difficulties. You should also research your financial advisors' academic qualifications. Is their background richer in sales than in finance? If so, why would you trust them with your life savings? To avoid paying for an advisor altogether, invest in a market index fund that will provide you with market returns without the anxiety of trying to find a hot stock or mutual fund.

> "Smart Investors never lose sight of the downside risk."

When your broker recommends a fund to you, ask, "why that fund?" Too often, money managers recommend a fund because selling it is more profitable for them. Reading the fund's prospectus will disclose the inducement paid to your broker. So, you are paying them for this advice, and so is the fund. Some brokerages have abolished fees and started charging a flat percentage of your portfolio's value. That means you pay them whether they earn a return on your investment or not. What a great deal for them. Remember, every dollar you pay them in fees enriches them and leaves you with a smaller investment portfolio. Save the money you would have paid in fees and invest it in an index fund.

> "Most investors should not invest in a hedge fund. For those who do, the investment should be limited to a very small percentage of their portfolio. Hyperactive brokers and advisors love them. The commissions are great."

Check how much your advisors really know about your portfolio by asking what its standard deviation, or level of risk, is. Do they know? Can they calculate it right there in front of you? Or do they need to ask someone else? Conservative portfolios should have a standard deviation of no more than 8%. Moderately aggressive portfolios will have a standard deviation around 15% and very aggressive portfolios around 20%. Only specialists should invest in a portfolio with a standard deviation above 30%. Even if brokers can't work out your standard deviation, you can be confident that they can calculate their fees quite accurately.

What Should You Avoid When Investing?

Asset allocation is the mix of stocks, bonds and cash (or cash equivalents) in your portfolio. The current fashion is to pour cash into stocks and minimize bonds. However, bonds move differently than stocks and help balance risk. Be careful about having too much of one and not enough of the other. Do not become so focused on the potential for higher upside returns that you fail to see the downside risk. You should also beware of funds that have different classes of shares. For example, some have A, B and C classes that vary in their associated fees, commissions and times when those dues are payable. If you decide to invest in these funds, be clear about your investing time horizon and how the fees will affect your return. Smart Investors do not put money in funds with different classes because they shun excessive fees. Avoid investing in brokerage house funds because market index funds usually trounce them.

> "Every academic who has ever studied this problem has found two things that correlate with superior performance. One is low transaction costs. The other is appropriate asset allocation."

Also avoid buying on margin, that is, using your existing shares as collateral against a cash loan to allow you to buy more shares. While your broker may extol the power of leverage, you need to be clear about the costs of borrowing and the risk of having to cover the margin if the equity declines. Hedge funds are also quite fashionable, but they are not for the average investor. If you cannot resist the urge, place only a miniscule part of your portfolio in these high-risk vehicles. Value stocks have been touted for many years, but they are highly volatile, with a standard deviation of more than 34%. A market fund will include these stocks while dampening their risk.

> "Investors should own the entire market. By 'the entire market,' I mean a broadly diversified portfolio of investments in domestic and international markets."

This common sense information may seem hard to come by, but the truth is out there. Authors like John Bogle and Burton Malkiel are very much worth reading. But new titles grab a lot of attention and their claims are sexier. The financial media need novelty and that means touting bad ideas simply because they are new. Economics journalist Jane Bryant Quinn called this emphasis on hot picks and easy methods for huge returns, "financial pornography." If you read Bogle and Malkiel along with this book, you will see how simple Smart Investing really is.

> "Nothing is more important than your asset allocation."

Are you operating under the notion that the broker with whom you have entrusted your entire life savings is obliged to invest your money responsibly? Licensed investment advisors are, but brokers operate under the "Merrill Lynch Rule" that holds them to a different standard, and allows them to exploit you and turn you into a hyperactive investor. When your investment advisor recommends a hot pick, ask whether it meets the "Prudent Investor Rule." This states that money managers should seek market returns rather than pursuing risky investments that might result in little return or loss. When you open an account with a brokerage read the fine print. Does it require you to settle disputes by mandatory arbitration rather than going to court? Do you trust their hand-picked arbitrators to be independent? Smart Investors almost never need the courts or arbitration of any kind.

The Four Steps of Smart Investing

The four simple and stress free steps to becoming a Smart Investor are:

1. Pick your asset allocation mix.
2. Open an account with Vanguard, Fidelity, T. Rowe Price or another similar service.
3. Invest your money in the index funds that provide you with the right market coverage.
4. Adjust your investments every six months to restore the right asset allocation.

> "You can take control of your own investments with minimal time and effort – and by doing so you are likely to outperform the vast majority of these 'investment professionals'."

Depending on your tolerance for risk and your stage of life, you have to decide whether you want to allocate your assets in a low-risk, medium-low-risk, medium-high-risk or high-risk portfolio. You can fill out a questionnaire at a number of different Web sites to help you determine where you fall in the spectrum. Remember, the risk is not just about seeking higher returns, it is also about exposing yourself to more possible loss. The low-risk portfolio had an annual average return of 9.22% and it experienced a loss of 1.69% in its worst year during the period 1970-2004. The high-risk portfolio returned an average of 10.69% and its worst single-year loss was 18.70% during the same period. The other categories achieved returns between these figures.

> "So who still believes markets don't work? Apparently it is only the North Koreans, the Cubans and the active managers." [– Rex Sinquefled]

Many firms, such as Fidelity and Vanguard, have made it quick and easy for Smart Investors to open accounts. They have a variety of products and tools you can use to reach your investing objectives. T. Rowe Price is another no-load firm with great products, but you have to invest in more funds to accomplish the coverage you want. Each of these companies facilitates investing in smart money. For example, if you wanted to invest $50,000 at Vanguard to create a medium-high-risk portfolio, you would put 42% or $21,000 in the VTSMX, 18% or $9,000 in the VGTSX, and 40% or $20, 000 in the VBMFX. These three funds expose you to the total U.S and international stock markets, and balance them with a bond market index. After six months, the value of these three funds will probably drift one way or the other. You can bring them back into the 42-18-40 balance by investing more to bring the balance in line, or you can sell those that have gained and buy some of those that have fallen. Rebalancing to get your investments in the right ratio takes 45 minutes twice a year.

If your primary retirement investments are in a company administered 401(k) plan, invest them in index funds. However, also look at the fees being charged on your investments and how much your plan administrators are churning the assets your funds hold. Complain to your HR department if the funds you need aren't offered at your firm.

Remember these five things:

1. Do not invest with brokers and advisors who push a Hyperactive Investment style.
2. Do not believe you can pick stocks or time the market or actively trade stocks.
3. Don’t get caught up in the hype machine pushed at you by the financial media.
4. Smart Investors expect long-term returns from 7% to 11%.
5. If you build a “Smart Portfolio” using whole market indexes you will outperform most funds in the long term.

About the Author

Daniel R. Solin, a securities arbitration lawyer and speaker, is a principal at Academic Wealth Management. He also wrote *“Does Your Broker Owe You Money?”*
