JONATHAN BURTON

INVESTMENT TITANS

INVESTMENT INSIGHTS FROM THE MINDS THAT MOVE WALL STREET

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Investment Insights from the Minds That Move Wall Street

Jonathan Burton

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For Lisa, Nicholas, Daniel and Ava:

The Most Rewarding Investment of All

Preface

A finance professor and his student were walking on campus one afternoon, deep in discussion about money and investing, when the student spied a $20 bill on the ground. Eagerly, he reached down to pick it up. "Don't bother," the professor said blandly. "If it were really there, someone would have taken it already."

Opportunity presents itself in unusual places. This book is a story of opportunities gained and lost. Its foundation was set in late 1996, when Barry Vinocur, editor in chief of what was then *Dow Jones Asset Management*, came to me with a unique idea for a series of question-and-answer interviews. What if I contacted pioneers of finance and investment and talked with them in-depth about their groundbreaking work, their insights about investing and their current view of the financial markets?

These great thinkers, many of them Nobel Prize winners and would-be winners, created the theories and concepts that Wall Street later turned into investment products and strategies. It would seem that these authorities would have much to say about how to be a better investor.

As a business and personal finance journalist, I was familiar with the research and published papers of luminaries like Harry Markowitz, Paul Samuelson and William Sharpe. But I had never actually spoken with them about the innovative ideas that had brought them fame.

"Leaders in Finance" debuted in January 1997, featuring a spirited conversation with Nobel Prize–winning economist Gary Becker about stock-market volatility and people's ability to cope with adversity. Over time, the series developed into regular discussions of investment risk and reward, the lessons of history, and the unique advantage that comes from being an informed investor. Many notable economists and investment professionals have contributed their sagacious insights, including Markowitz, Samuelson, Sharpe, Peter Lynch, the late Merton Miller, Eugene Fama, Jack Treynor, Gary Brinson and Peter Bernstein.

Asset Management is a bimonthly magazine for institutional investors and investment advisers—a relatively sophisticated readership. My challenge for the series—and for this book—has been to make complex subjects accessible to people who might not have an MBA. Investing is not rocket science, despite Wall Street's best efforts to make it so—except for the fact that launching a rocket also requires a good deal of common sense and informed judgment.

It is my hope that readers of *Investment Titans* will learn more about investing than they already knew, regardless of their expertise. Buying and selling stocks is hard work—your hard work. This book offers a concrete and helpful understanding of investment strategies, as seen through the eyes of some of the most unique thinkers in the investment business.

Investment Titans also is a story of risk and how we handle it. Investors tend to focus on investment returns and ignore the inherent risk. To the investment manager who boasts proudly, "We beat the market," the question should be: "Did you take above-market risk?" Unwelcome as it may be, there is always a trade-off between risk and reward. Investors need to make a realistic and honest assessment of their risk tolerance, for portfolio risk is one of the few factors within their control. Portfolio return, unfortunately, is not.

Through exclusive interviews, the nine distinguished subjects of *Investment Titans* generously have offered their most lucid ideas and insights to help people invest more wisely. Each chapter covers a different aspect of investing, including:

- Stock-market risk and reward
- Time horizon and the long-term power of stocks
- Indexing
- Value versus growth investing
- Investor psychology
- International investing strategies
- Determining your risk tolerance, hiring a financial adviser and using the Internet to manage your portfolio

Underlying each of these themes is a central question: "Can you beat the market?" If not, why? If so, how? Finance experts are split on this issue. Many of the investment titans in this book contend that the answer to "Can you beat the market?" is a resounding "No." It's nearly impossible to predict stock prices, they claim; throwing darts at the stock pages or taking a "random walk" across a list of ticker symbols would generate about the same results. Markets are too efficient; mistakes are instantly spotted.

For these "efficient-market" disciples, the investment landscape is cut and dry. Since most professional investors fail to hurdle their benchmark, individuals have even scarcer hope of finding undiscovered gems that will make them rich. Any famed investor who has consistently outperformed, like Warren Buffett or Peter Lynch, is a statistical quirk—a sideshow to Wall Street's Big Top. So stop trying. Instead, invest in passively managed mutual funds that track a market index. Asset allocation—how much you confer on stocks and bonds—not stock selection, is most important to meeting financial goals.

The random walkers present a strong case. But other respected thinkers in this book argue that stock price movements are in fact predictable, markets can be exploited through diligent research, and gold can be mined by those who dig hard and deep. Yet if it is possible to go "One Up on Wall Street," as Peter Lynch outlined in his 1989 best-seller of the same title, it's also true that many well-informed people are chasing similar opportunities. *Investment Titans* aims to tear down the Wall and steer you safely across the Street. Here are highlights of what to expect from each chapter:

- Harry Markowitz is an unlikely father of modern finance. As a young graduate student at the University of Chicago in the early 1950s, Markowitz was waiting to meet with his dissertation adviser when he struck up a conversation with a stranger sitting next to him. The man, it turned out, was a stockbroker, and he encouraged Markowitz to study the stock market—perhaps the best advice a broker has ever given.

Markowitz soon was researching existing ideas about investment strategy, and in 1952 published a road map for investors to gauge the risk of their *entire* portfolio. To reduce exposure to unwanted risk, he argued, diversify holdings across many types of investments. Better to hold a basket of unrelated investments, Markowitz suggested, so that when one group is tumbling, another is appreciating. Diversification offers a smoother and happier ride over time. Sure, this sounds elementary now—Investing 101—but that's because of Markowitz, who shared the 1990 Nobel Prize for economic sciences. Before him, no one had explained why diversification mattered; there was no such animal as a "financial adviser." Memories of the Depression were fresh, and few Americans owned stocks. Indeed, a popular view of investing was simply to put all of your eggs in one basket and watch that basket carefully. Markowitz showed how shaky that basket can be.

• Paul Samuelson, another Nobel Prize winner and professor emeritus of economics at the Massachusetts Institute of Technology, takes issue with the notion that if you hold stocks long enough—10, 20, 50 years—you will not, cannot, lose money. He is familiar with statistics that show that the U.S. stock market has not suffered a loss in any given 15-year period since 1926. And he can see how statistics like this can convince investors that if they stay in equities long enough, they will endure less market risk and be assured of netting at least the long-term historical average annual return from stocks.

A nice idea, but untrue, Samuelson counters. Time does not heal all stock-market wounds. While he concedes that over the long term stocks likely will fare better than other assets, to invest on that assumption is dangerous. Risk does not go to zero over long periods, Samuelson contends. To think otherwise paints a false sense of security and complacency. And when stock prices crumble, your sweetheart investments could look scary. That could lead to poor short-term judgments and even outright panic. Indeed, Samuelson advises: "You shouldn't spend much time on your investments. That will just tempt you to pull up the plants and see how the roots are doing, and that's very bad for the roots."

- Jeremy Siegel, a professor of finance at the Wharton School, is the author of the best-selling *Stocks for the Long Run*. What exactly is the "long run"? Siegel explains that the long run is a lifetime, where the risk of being out of the game actually is greater than the risk of playing.

Siegel shares some bold views about stock-market risk. While Samuelson charges that stocks are riskier than bonds, regardless of time horizon, Siegel disagrees. His startling premise is that a stock portfolio held for more than 20 years is less risky than a portfolio of bonds. How can that be, when bonds are supposedly much more stable? Because over time economic inflation eats away at fixed-income returns, while stocks have beaten inflation handily.

- John C. Bogle, the founder of the Vanguard Group of mutual funds, is the closest thing that individual investors have to a folk hero. For half a century, this iconoclastic fiduciary has worked diligently to make investing simpler for people. Not that making money in the stock market is easy, because investing is no sure thing. Bogle just makes buying and selling funds easier to understand.

One of the easiest investment rules for people to follow, and Bogle's all-consuming passion, is minimizing expenses. As with portfolio risk, investment costs, such as the fees paid to mutual funds, are another crucial factor within an investor's control. "This business is all about simplicity and low cost," Bogle says. "I'm not into all these market strategies and theories and cost-benefit analyses—all the bureaucracy that goes with business. In investing, strip all the baloney out of it, and give people what you promise."

- Josef Lakonishok, a finance professor at the University of Illinois and a respected institutional money manager, is a staunch supporter of value investing. To a value investor, what goes down must come up. Value investors search for situations where they strongly believe that others have the picture wrong. Unlike investors who gladly fork over premium prices for shares of popular "growth" stocks, shareholders of value stocks refuse to pay homage and dollars to Wall Street's darlings. Instead they are devoted to Wall Street's dogs. In this chapter, Lakonishok shares his top investment secret, an inside tip that may surprise many stockholders. You'll also learn to recognize attractive value stocks and to analyze their current and future prospects.

• Are markets ruled by cold, calculated reason or heated, helter-skelter actions? Efficiency or emotion—which is it? Richard Thaler of the University of Chicago believes that investor psychology and human behavior dominate stock price movements. That means the market can be bested by those who stay cool when others overreact. Thaler ministers over a budding discipline called "behavioral finance," which contends that efficient-market models are seriously flawed. Investors are not always rational. Psychology matters. Emotions matter. And before the efficient-market types came along, legendary investors like John Maynard Keynes and Benjamin Graham routinely factored human nature into their investment strategies. In this chapter, you'll learn about the mind games that people play with money and the impulsive investing mistakes they tend to make—from trading too much to not trading enough.

• To Gary Brinson, the chairman of influential Chicago-based investment manager UBS Asset Management, stocks should be chosen according to business sectors, not borders. Where a company is based doesn't much matter, as long as it's a leader. Globalization will make borders and trade barriers obsolete, he claims, and stocks will trade around the clock on every major exchange.

Still, many savvy investors are convinced that their portfolios get enough international exposure from holding U.S.-based multinational corporations with worldwide reach. Indeed, giants like Coca-Cola generate most of their revenues outside of the United States. Investment sage Warren Buffett has taken this very approach with Berkshire Hathaway's stakes in Coca-Cola and Gillette, for example, a strategy that Brinson challenges with two sharp words: "Warren's myopic," he snaps.

Investors will increasingly accept a broad, borderless view of the world, Brinson counters, and will become more comfortable with the stocks of companies that are not so close to home. And he offers fundamentally sound investment advice on how to navigate this developing trend and profit from it.

- As a chronicler of the history of investing and its guiding theories, best-selling author and investment counselor Peter Bernstein is a one-man Greek chorus for the events, people and principles that have shaped finance and investment over the past half-century.

Bernstein has been described as a master of the "art of holding hands." He is a voice of reason for those many investors who have not yet experienced a full-fledged bear market. "The stock market doesn't know you're there, and it's not going to be considerate," he warns. "You don't *deserve* to get anything, really. The market is not an accommodation machine. It owes you nothing."

In Chapter 8, Bernstein talks at length about the characteristics of a good investor. Be realistic, and accept uncertainty, he advises. He also has plenty to say about the giddy love affair with stocks that has swept so many people off their feet during the past few years.

- William Sharpe has rolled out an assembly line of useful investment tools, including the Capital Asset Pricing Model, or CAPM, and the Sharpe Ratio. Want to know how much risk a mutual fund manager is taking with your money in an effort to beat the market? The CAPM tells you. It says that just being in the stock market is a risk you can't eliminate, so the way to get superior, market-beating investment returns is to take on bigger risks—for which you could incur big losses. Don't want to compete? The CAPM gave rise to passive investing through index funds.

Sharpe later developed the Sharpe Ratio, which is now a standard measure of whether fund managers are good at their jobs.

The higher the ratio, the better the fund's risk-adjusted return. Today Sharpe, a computer buff, is democratizing finance through the Internet with an investment-planning vehicle called Financial Engines—revolutionizing individual investing as he shook professional money management in the early 1960s.

It has been a true privilege and a tremendous professional opportunity for me to speak with each of these pioneers. I have tried in this book to interpret their views in ways that many people can appreciate. Owing to space considerations, three important interviews with prominent investment titans regrettably were not included. These men are: Burton Malkiel, author of the influential *A Random Walk Down Wall Street*; Roger Ibbotson, the innovative founder of securities data firm Ibbotson Associates; and Martin Leibowitz, vice chairman and chief investment officer of the teachers' pension fund TIAA-CREF.

Malkiel's salient views and Ibbotson's work and data are referenced in several chapters. Leibowitz is a towering force in fixed-income investing, the man who literally wrote the book about how to understand and value bonds. But after a gracious, informative talk with him, I decided to keep the spotlight of this book exclusively on stocks. The responsibility for any other omissions and errors, and may there be few, is mine alone.

Yet in the end, one piece of eloquent investment advice from Leibowitz stands out: "Good ideas can slip between the cup and the lip," he said. "In this business, one can have a great cup, a wonderful brew, and it doesn't get turned into reliable long-term returns. And just because something works out well and turns out to be a wonderful investment doesn't mean one should automatically take a victory lap. The overall process is the key to long-term results. So don't crow when you have a success. Think hard about where that success really came from."

Be thoughtful and appreciate your success—such judicious counsel applies to so much more than investing.

Jonathan Burton

Acknowledgments

Writing may be a solitary pursuit, but gathering the important and illuminating information necessary to create a compelling work is always a collaborative effort. This book is no exception.

Heartfelt thanks are due first to Barry Vinocur, former editor in chief of *Dow Jones Asset Management*, who had the vision to create the "Leaders in Finance" series and the confidence to let me use my best judgment to shape and edit often-complex interviews into colloquial and approachable magazine pieces.

Over three years and many lengthy discussions with Barry about strategy and direction, "Leaders in Finance" developed into a must-read for the institutional investors and financial advisers who receive *Asset Management*. To the many readers who took the time to write an appreciative note about the series, I'm pleased and grateful that you consistently found the interviews as informative to read as I have found them to write.

To the pioneers of finance and investing who opened their minds to me so that I could write this book, you have my deepest gratitude. I hope this finished work accurately reflects the wisdom of your words and insights.

To the other incomparable thinkers who have been profiled in "Leaders in Finance," thank you for helping bring an idea to fruition. Many of you are university professors, and this series—now in its fourth year—has been my graduate school. You have taught me much about what it means to be a better investor. I have tried to incorporate these lessons in my reporting about personal finance and investment trends and tactics. If only space and time would have permitted me to feature each of you in this book.

Special thanks is due to Charles Ellis of Greenwich Associates, one of the brightest assets of the investment management business. In a casual conversation a couple of years ago, he suggested that "Leaders in Finance" could be turned into a noteworthy book, and put me in touch with an editor at McGraw-Hill named Jeffrey Krames.

I have worked with many editors during my journalism career, but few with Jeffrey's tenacity and inspiration. He saw this book's potential from the start, and has stood by it every step of the way. Jeffrey has been the singular driving force behind the scenes of its production, challenging and encouraging me to create an even better work than I originally envisioned. Thank you, Jeffrey.

Some portions of this book appeared in similar form in pieces that I wrote for *Dow Jones Asset Management*, *Bloomberg Personal Finance*, *Individual Investor* and *Online Investor*. Thanks to Barry Vinocur, Steve Gittelson, editor of *Bloomberg Personal Finance*, Paul Libassi, editor of *Individual Investor,* and Jan Parr, editor of *Online Investor*, for allowing the essence of these articles to reach a wider audience. Thanks also to my good friends Brian Maddox, Alexis Sinclair and Ken Krimstein—each creative writers and confidants—who gave me intelligent advice about managing a book project, and to Daniel Kornstein, who provided astute professional counsel. At research firm Ibbotson Associates, Jamie Martin and Alexa Auerbach graciously provided invaluable investment data, as did Annette Larson at mutual fund- and stock-rating service Morningstar.

My time is given primarily to reporting assignments and to my family. Lisa and the kids have been understanding and supportive throughout this period, making room in a busy schedule so that I could work. For that, and much more, I am most appreciative. And so, to my three wonderful children, who would never cease to ask innocently, "What chapter are you on, Daddy?" I can now say, "The last one, honey."

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