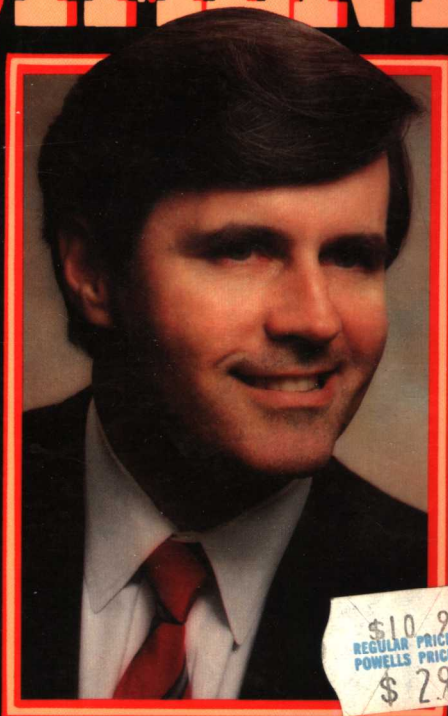


WINNING THE INVESTMENT GAME

A GUIDE
FOR ALL
SEASONS



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JAMES GIPSON

LET A TOP-RATED ECONOMIC ADVISER SHOW YOU
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CLIMATES AND IN ALL ECONOMIC SEASONS.

WINNING THE INVESTMENT GAME

A GUIDE FOR ALL SEASONS

JAMES H. GIPSON

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For my wife and for my mother

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CONTENTS

ONE. THE NAMES OF THE GAMES 1

The Theory of the Three Games in a Nutshell	2
Economics and Investing—The Economy Calls the Game	2
Economics and Investing—Why the Conventional Approach Does Not Work	3
The End of an Investing Game	5
Why Games End—The Logic of Investing	6
The Influence of Keynes	8
Investing as a Game	8

TWO. THE LAST NEGATIVE SUM ECONOMY 10

Confidence on the Eve of the Great Depression	10
The Party Ends	11
The Blunders	12
The Breakdown of Conventional Economics	15
The Rise of Keynes	17
Why We May Have Another Depression	19
The Recent Controlled Depression	21
An Uncontrolled Depression Starts with a Financial Crisis	23
A Possible Solvency Crisis	24
Europe's Potential Financial Crisis	33
Timing, Mistakes, and Surprise	34
Signs of Another Uncontrolled Depression	35
A Depression Is Not All Bad	37

THREE. THE NEGATIVE SUM INVESTING GAME 38

Conventional Wisdom	39
The Losers—Debtors	40
The Losers—Real Estate	42
The Losers—Precious Metals	47
The Losers—Antiques and Other Collectibles	49
The Losers—Common Stocks	50
The Winners—Bonds	51
The Winners—Cash Equivalents	53

FOUR. THE ZERO SUM ECONOMY 56

The Financial Causes of Inflation—The Paper Economy	57
The Fiscal Causes of Inflation	63
The Social Causes of Inflation	65
Fear and Pain	68
The Sticky Economy	70
The Invisible Hand Points the Wrong Way	71
Secular Inflation	72
Keynes in Eclipse	73
The Philips Curve	76
For Better or Worse, but Not the Same	77
Nonsolutions to Inflation	78
Recognizing the Zero Sum Economy	81

FIVE. THE ZERO SUM INVESTING GAME 83

The Federal Reserve Changes the Rules of the Game	83
No Place to Hide	85
Bonds	86
Cash Equivalents	90
Real Estate	91
Gold	98
Stocks	101
Diamonds	103
Tangibles	103
Timing	104

SIX. THE POSITIVE SUM ECONOMY 105

The Economic Causes of a Positive Sum Economy	105
The Financial Causes of a Positive Sum Economy	109
Corporate Finances in a Positive Sum Economy	112
International Causes of a Positive Sum Economy	113
Marginal Returns versus Average Returns	115
The Triumph of Keynes	115
Stable Prices	118
The Hero of a Positive Sum Economy	118
The End of a Positive Sum Economy	120

SEVEN. THE POSITIVE SUM INVESTING GAME 123

The Winners—Common Stocks: The Income Statement and the Balance Sheet	123
The Winners—Common Stocks: Profits and Dividends	128
The Winners—Real Estate	129
The Losers—Bonds and Cash Equivalents	130
The Losers—Collectibles	131
The Losers—Gold and Silver	132

EIGHT. FINE TUNING 134

The Business Cycle	134
Stocks	135
Real Estate and Tangible Assets	136
Bonds and Cash	137
Combining Leads and Lags	139
Caveats	140

NINE. WHERE DO WE GO FROM HERE? 141

The Negative Sum Economy—30 Percent Probability	141
The Zero Sum Investing Game—60 Percent Probability	144
Another Possible Scenario for a Zero Sum Economy	145
The Positive Sum Economy—10 Percent Probability	147

TEN. THE VIRTUES OF INVESTING 151

Contrary Thinking	151
Patience	155
Diligence, or Knowledge Is Profit	157
Value Orientation	158
Clearly Defined Objectives	162
A Cool Head, or Fear and Greed Overcome	163

APPENDIX. MODERN PORTFOLIO THEORY 166

The Jargon	166
Beta	168
Extramarket Covariance, or How Groups of Stocks Move Together	170
The Random Walk through an Efficient Market	172

INDEX 175

CHAPTER ONE

THE NAMES OF THE GAMES

Making money and keeping it is the payoff from playing the investment game well. As in tennis or golf, winning in the investing game requires the players to recognize what game is being played, learn its rules, and then practice until they are more proficient than their opponents.

Recognizing what game is being played is easier said than done. The basic idea of this book is that there are three distinct investment games, each of which may last for as long as a generation. Each game sows the seeds of its own destruction, and then another game begins. The largest profits belong to investors who correctly recognize the current game (most investors, like French generals, are too busy fighting the last war to win the current one) and play it well. The worst losses accrue to investors who fail to recognize the name of the current game or fail to recognize when games change.

This chapter summarizes the theory of the three basic investment games and suggests which assets do best and worst in each of them. Chapters 2 to 8 deal with the past and summarize how investors prospered and perished in the last three games from 1929 to 1980. Chapter 9 deals with the future and offers the author's ideas as to where we go from here. Chapter 10 explains the virtues of investing where virtue is more than its own reward.

THE THEORY OF THE THREE GAMES IN A NUTSHELL

Investment assets are like fruits which mature in different seasons. No single asset is good during all seasons, but each one can be very profitable at the right time. The three major investment games determine the right season for each of the major assets available to investors: stocks, bonds, cash, real estate, gold, and tangible assets such as coins, stamps, antiques, and art.

The positive sum game is the the best of all possible worlds. Growth is good and more growth is better. Common stocks do very well, particularly if those stocks are in companies enjoying rapid real growth in goods or services they produce. Real estate does well if located in a growth market. Cash, bonds, and tangible assets are likely to be losers both in real terms and in comparison with better opportunities available elsewhere. The golden age of growth and the positive sum investing game was 1950 to 1973.

The zero sum investing game is like poker where there is a loser for every winner. New wealth is not created by working hard, saving frugally, and investing intelligently. Instead, existing wealth is shifted around the table in favor of clever players who capitalize on inflation. Real estate, gold, and tangibles all do very well as investors rush from a rotting dollar into assets which they hope will preserve the real value of their capital. A few common stocks do well if they are in exceptional companies which capitalize on inflation, but most stocks lose value in real terms. Cash equivalents such as Treasury bills are losers in real terms, and bonds are a prescription for financial euthanasia. The inflation which took off in 1973 began the zero sum investing game of the 1970s.

The negative sum investing game is the worst of all possible worlds. As the real wealth of society contracts in a long depression, most investors lose money in tangible assets and in gold. Real estate and stocks are also losers unless their rents and profits are very stable. Cash equivalents and bonds, which produced nothing but real and opportunity losses during the previous two games, emerge as unexpected winners. The depression of the 1930s was the last major negative sum investing game.

ECONOMICS AND INVESTING— THE ECONOMY CALLS THE GAME

Common sense rightly suggests that the economy has a powerful influence on investing success. Common sense, unfortunately, does not sug-

gest precisely what that influence is. The conventional approach (next section) tries and usually fails to use short-term forecasts of the economy as the basis of intelligent investment decisions. A less conventional but more straightforward approach is to use the long-term state of the economy to indicate which investing game to play.

The dominant trend in the economy determines which investing game is profitable to play. The three investing games are merely reflections of the long-run trend of the economy: positive sum, zero sum, and negative sum.

The creation of real wealth is the dominant trend of a positive sum economy. Growth of the labor force, improvements in education, advances in technology, and investment in capital goods combine to multiply the real wealth available to society. Prices remain stable or rise only moderately in relation to the gains in real GNP. The way to capitalize on this creation of real wealth is to invest in the stocks of companies which create that growth and in real estate which benefits from it. The 1950–1973 period was the last great positive sum economy.

The transfer of real wealth, not its creation, is the dominant trend of a zero sum economy such as the United States experienced in the late 1970s. As real economic growth slows down and inflation heats up, the energy of intelligent men and women shifts from working to enlarge the nation's economic pie to fighting for an enlarged piece of it. Inflation is the peaceful means by which wealth and income are transferred from inept players to adept ones; revolution is the traditionally less peaceful means. The major opportunities available to investors are the beneficiaries of inflation: gold, real estate, and tangible assets.

The destruction of real wealth is the dominant trend of a negative sum economy. Depressions are nasty events, but they are the only sure cure for inflation. A depression is most dangerous when it slips beyond the ability of government to control it or when it is compounded by the well-intentioned blunders of people in power. Caught in a shrinking economy, most investors see the real value of their assets shrink too. The few investors who increase the real value of their assets are ones who play the negative sum investing game.

ECONOMICS AND INVESTING— WHY THE CONVENTIONAL APPROACH DOES NOT WORK

Money may be managed profitably or conventionally, but not both. A recurring theme of this book is the need for an investor to take a contrary, unconventional approach toward investing. The failure of the

conventional approach of relating economics to investing is one example of the need for contrary, unconventional thinking.

The conventional approach uses a short-term economic forecast as the basis for predicting stock prices. If a recession is predicted, then stocks are sold now in the expectation that they will decline along with the earnings of the companies they represent. If capital spending is expected to be strong next year, then stocks of capital goods producers are purchased now. This conventional approach has a great deal of intuitive appeal and only one drawback—it does not work in producing superior investment returns.

The problem with the conventional approach is that the stock market anticipates the economy rather than the other way around. The Commerce Department uses 12 leading indicators to forecast the economy's direction, and the stock market is one of the best of those leading indicators. By the time a recession is apparent, the stock market generally has declined already. The stock market generally hits bottom about 6 months before the economy does and it rises long before recovery is apparent. The bear market of 1973 to 1974 was a prime example: the stock market peaked nearly 1 year before the recession began in the fall of 1973 and then bottomed in the fall of 1974, 6 months before the economy began to recover.

The stock market represents the consensus of millions of well-informed investors (and millions of badly informed investors too). By the time an investor recognizes that some major economic change is under way, it is probably old news to millions of other investors. *The price of stocks today reflects the consensus of investors' expectations about the future, so investors are unlikely to make money unless their expectations about the future are both correct and significantly different from the consensus.*

An individual investor who employs the conventional approach of using economic forecasts to predict stock prices is at a significant disadvantage to institutional investors with far greater resources at their disposal. Bank trust departments, insurance companies, and large investment counselors use a great deal of brainpower and computer power to make highly detailed short-term forecasts of the economy; they are far more likely to spot changing economic patterns than an individual investor is.

Many individual investors feel intimidated when they realize they are competing against the vast human and computer resources of institutional investors. They shouldn't. True, institutional investors have competent economists who work long and hard to produce forecasts which are not available to individual investors. Also true, however, is that many of those forecasts are dead wrong. In late 1973 most econo-

mists predicted a "soft landing" for the economy in the following year, not the worst recession in 40 years which actually occurred. In the 8 quarters of 1980 through 1981, the consensus of economists was wrong an amazing six times about whether real GNP would go up or down over the next 3 months.

Institutional investors often are wrong in their economic predictions, but they still stand a better chance of being right than the average individual investor. Being right, however, is usually not very helpful. Like other human beings confronted by an uncertain future and by unpleasant consequences for being wrong about the future, most economists huddle together for safety and thereby produce broadly similar economic forecasts. Most economists use similar economic models and common sources of data such as those provided by the government and Data Resources, Inc., so it is hardly surprising that their forecasts resemble each other closely. Each forecast generally contains a few small differences from the consensus to show that the forecaster has done some work, but those differences are seldom enough to produce superior performance.

The bottom line of superior performance is where the conventional approach really breaks down. Long-term studies of performance by monitoring firms such as A. G. Becker indicate that up to 80 percent of institutional investors *underperform* the market over 5-, 10-, and 15-year periods. Most institutional investors do well once in a while (a phenomenon known in the business as "every dog has its day"), but there is depressingly little evidence to show that institutions really deliver superior returns. So much evidence about the mediocrity of institutional investors accumulated in the late 1960s and early 1970s that the random walk theory (also known as the efficient market hypothesis) was born, a subject covered in greater detail in the Appendix.

THE END OF AN INVESTING GAME

No game lasts forever. Merely recognizing that fact gives an investor a major advantage over most other investors who project the trends of the immediate past into the indefinite future. Any single game may last as long as a generation, but eventually it sows the seeds of its own destruction and another game emerges. The end of a game is a messy affair which creates a crisis for investors.

A crisis is not all bad. The Chinese recognized that fact when they created the symbol for the word "crisis" by combining the symbols for

two other words: danger and opportunity. A major element of successful investing is avoiding the dangers presented by a new game while capitalizing on its opportunities.

The dangers are always more apparent in retrospect than in the euphoria which accompanies the end of a game. Few investors in the excitement of 1929 realized how badly stocks would perform during the negative sum investing game of the 1930s. More recently, few investors in the roaring bull market of the late 1960s realized how badly stocks and bonds would perform during the zero sum investing game of the 1970s. Even more recently, many investors in 1979 believed that real estate prices only go up, a belief which was very hazardous to their financial health.

The other side of danger is opportunity. The negative sum investing game of the 1930s created a great opportunity for holders of cash and bonds to increase the real value of their capital. A similar opportunity existed for gold, real estate, and other tangible assets during the zero sum investing game of the 1970s. Opportunity is present in every game, particularly in times of greatest crisis. One of the early Rothschilds observed that the time to buy is when blood is running in the streets; a modern version of that observation is that opportunity is at its maximum when investors are just plain scared.

Danger and opportunity are the two constants of investing. They are always present, but are not always apparent. Only the opportunity to jump on the bandwagon was apparent to most stockholders in 1969 and to most property owners in 1979, but danger was at its greatest point for both groups of investors then. Because the end of an investing game creates a whole new set of dangers and opportunities and because recognizing them is so critical to investment success, each of the three following chapters on the three games has a separate section on how to recognize the current game and how to tell when it changes.

WHY GAMES END—THE LOGIC OF INVESTING

Once a game goes on for a decade or more, there is a temptation to think it will last forever. The reason why no game lasts forever goes to the heart of an often unquestioned assumption about the form of logic investors should use.

Most investors use linear logic, a method taught in science courses to every high school student. If water boils at 100°C in 1000 straight experiments, then the odds are very good that it will boil at that same

temperature on the next try. If the sun has risen in the east every morning since the dawn of history, then one may conclude that it will rise from that direction tomorrow. An event or trend in nature, once identified, generally goes on forever, so linear, or inductive, logic makes the reasonable assumption that the future will resemble the past in a highly predictable fashion.

Linear logic is very useful for the natural sciences, but not for investing. The trends of the immediate past never extend into the indefinite future, although they may persist for many years. No asset—stocks, bonds, gold, real estate—goes up or down forever. Linear logic is not very useful in explaining why one investment trend ends or what trend will replace it, but another form of logic is.

Dialectic logic has a forbidding name, which is natural in light of its origin. A German philosopher named Hegel developed it, and another German philosopher named Marx vigorously exploited it. Both Hegel and Marx wrote in a ponderously Teutonic fashion which endears them only to masochistic readers who thrive on frustration. Behind its frustrating terminology, however, dialectic has two stellar virtues: it explains why trends change, and its basic ideas are reasonably simple.

Explaining why trends change is the major use of dialectic. Human events do not proceed in the neat, orderly fashion that events in the natural sciences do; instead they are filled with crises, turning points, and changes of direction. Dialectic recognizes this by starting with a trend (called a *thesis*) which goes forward under its own momentum until it reaches an extreme and then generates forces (called an *antithesis*) which deflect and change it. The clash of old trend and opposing forces creates a new trend (called a *synthesis*) which develops a life and momentum of its own and starts the process all over again. If this all seems a bit abstract, then consider a concrete example of one of the dominant trends of the last two generations: the trend toward greater government involvement in the economy, which began in the 1930s as the *solution* to the problem of the depression. After 50 years of growing power, government came to be viewed as the *cause* of problems such as inflation and excessive bureaucratic regulation.

The old trend toward greater government power generated conservative forces to oppose it. Margaret Thatcher and Ronald Reagan are the political results (and partially the political causes) of popular dissatisfaction with ever-expanding government power. The clash between the liberal momentum of growing government power and the rising tide of conservative opposition to it is producing a new attitude toward the proper role of government in the economy which will refocus and transform government power in the 1980s.

A major element of dialectic is recognizing that the solution to one problem (e.g., federal fiscal stimulus was the solution to the depression of the 1930s) generally goes to an extreme where it becomes the cause of another problem (e.g., too much fiscal stimulus became the cause of the inflation of the 1970s).

Merely recognizing that trends change confers a large advantage on an investor which is not shared by investors who take a linear view of the nonlinear investing world. Understanding why trends change confers a still larger advantage, which is the reason that a dialectic approach is employed in analyzing past investing games and why they ended. Dialectic is not difficult, but like any other new mode of thinking or acting, it takes a while to become accustomed to it. Lord Keynes expressed a similar idea in the introduction to his *General Theory of Employment, Interest, and Money*: "The difficulty lies, not in the new ideas, but in escaping from the old ones."¹

THE INFLUENCE OF KEYNES

For better and worse, the ideas of John Maynard Keynes have dominated twentieth-century economics. He went from heretic in the 1930s to savior in the 1960s and then on to villain in the 1970s, although his own life ended before he could see those last two stages. Because Keynes left such a large and enduring stamp on our time, many parts of the following chapters deal with the uses and abuses of his ideas.

INVESTING AS A GAME

At first, investing seems too serious a subject to treat as a game. Money is at stake, often the money an investor needs to pay bills. On closer inspection, however, investing really does have many similarities to a game like tennis or golf.

Like any other game, investing has both winners and losers. The winners are those who learn the rules of the game they are playing and who diligently practice it until they are proficient. This book is a guide to the rules of the three major investing games open to investors.

¹John M. Keynes, *The General Theory of Employment, Interest, and Money*, Harcourt Brace Jovanovich (Harbinger), New York, 1964, p. viii.

Like any other game, investing requires that players master themselves before they can win. Holding a golf club or tennis racket too firmly almost guarantees that an excited player will hit the ball some place other than where he wants it to go. The emotional investor who gets carried away with the euphoria of a bull market or the fear of a bear market is equally unlikely to make intelligent moves. Investing is a game which requires investors to become aware of their emotions and to master them.

Also like any other game, investing can be fun. It is an exciting intellectual challenge in a constantly changing world. Even the best investors miss often enough to keep them alert and interested in doing better the next time. There is enough room for improvement to last a lifetime. Unlike most other games, however, investing can be both fun and financially profitable to the good recreational player.

CHAPTER TWO

THE LAST NEGATIVE SUM ECONOMY

They said it could not happen. Conventional wisdom in 1929 said that permanent prosperity had been achieved and that economic collapse was impossible. In just 4 years 25 percent of the labor force was out of work in the worst economic catastrophe in the nation's history. Two generations later, Keynesian economists confidently believed that they too had banished the business cycle and guaranteed perpetual prosperity. Unfortunately no one can guarantee prosperity, and depressions are not only possible but necessary. A brief look at the causes of the last depression yields three conclusions about how another one might happen.

CONFIDENCE ON THE EVE OF THE GREAT DEPRESSION

Like a Shakespearean tragedy, it began in triumph and ended in disaster.

There was much to feel triumphant about in 1929. The U.S. economy grew steadily through the 1920s and created a standard of living which was the envy of the world. The European economies never quite recovered from World War I, but that was the problem of the old world. The new world was showing the rest of the planet how it was done.