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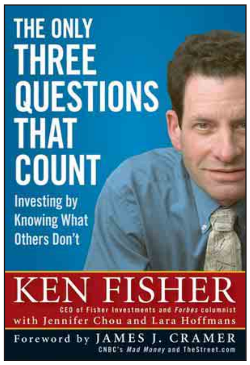

The Only Three Questions That Count

Investing by Knowing What Others Don't

by Ken Fisher, Jennifer Chou and Lara Hoffmans
John Wiley & Sons © 2006
480 pages

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Take-Aways

- Investors should ask three basic questions. First, ask which of your beliefs is false.
- Second, ask whether you understand something that others do not understand.
- Third, ask whether you are the victim of a cognitive delusion.
- Recognize that professionals are often wrong.
- You cannot hope to make money by using information that is available to everyone.
- There's no harm in high oil prices – in fact, we should pray for them.
- High government deficits are good for the stock market.
- Borrowing, even for governments, is economically prudent if the return on investment is greater than the cost of borrowing. By this measure, the U.S. ought to borrow more.
- Bear markets seldom last longer than 18 months.
- Picking the right stocks to buy is only half of investing success; the other half is knowing when to sell.

Rating (10 is best)

Overall	Applicability	Innovation	Style
8	**9**	**6**	**7**

Relevance

What You Will Learn

In this Abstract, you will learn: 1) What three fundamental questions investors should ask to avoid losses and improve their probability of success; and 2) How conventional wisdom is surprisingly wrong about market performance, government spending and borrowing, and other economic factors.

Recommendation

Ken Fisher is one of the most famous market pundits and money managers in the United States, and one of the few to occupy a spot on the *Forbes* list of America's richest people. In this book, he debunks conventional wisdom and widely believed folklore about securities markets and the process of investing. He suggests a sort of investors' examination of conscience: They should routinely ask themselves three simple, straightforward questions to ensure that they are not falling into avoidable error: Which of my beliefs are false? What can I understand that others cannot understand? And, what cognitive illusions are fooling me now? He provides ample supporting research to buttress his assertions about the market and, more to the point, to topple the false wisdom that leads so many investors to failure. *getAbstract* finds that Fisher is lucid, strongly opinionated, sometimes a bit of a crank (a long tangent on Gertrude Stein seems particularly out of place in this book) but, on the whole, well worth reading.

Abstract

Useless Information

Markets are very good at incorporating information into securities prices. Anything that you read in the newspaper or hear on television or radio, about any investing system, set of investing rules, guidelines or principles about earnings, prices, economic directions or management, is already reflected in the stock price. You cannot hope to gain an edge against the market by using information that the market already has. Most professional money managers and investors, notwithstanding their extensive educations, and expensive arsenal of computer power and databases, fail to match – much less beat – the market index.

"The more jerry-rigging and qualification your analysis needs, the more likely you are forcing your results to support your hypothesis. Forced results are bad science."

Investing is not a craft. No skill set exists that you can simply master and then be assured of market-beating success. Consider the example of Warren Buffett. Many people think he is an outstanding money manager, however, Buffett actually is not a money manager. Rather, he is the head of an insurance company that happens to own some stocks. Berkshire Hathaway, Warren Buffett's company, has been a laggard stock of late. Moreover, those who modeled their investment approach on Mr. Buffett's tactics have not excelled either.

"Never forget how fast the market moves."

In fact, success in investing isn't a matter of following rules, but of asking questions. Investors should ask themselves three fundamental questions:

1. Which of my beliefs are false?
2. What can I understand that others cannot understand?
3. What cognitive illusions are fooling me now?

"There is an overabundance of highly educated and experienced professionals who invest as stupidly as rank amateurs."

Question One: Which of My Beliefs Are False?

Most people hold false beliefs. For example, many investors believe that the price-to-earnings (P/E) ratio is a reliable, shorthand metric of risk and return. In fact, the P/E ratio does not contain useful information. The utility of the P/E ratio is an article of faith, widely held, yet false. Many such fictitious articles of faith abound. Investors must shed these myths, including:

- A high P/E ratio is a sign of high market risk.
- Government deficits are undesirable and America has overborrowed.
- Stocks are bound to suffer when the dollar weakens.
- Trade deficits hurt the stock market.
- Stock prices move inversely to interest rates, so high rates are bad news for equities and low rates are good news.
- Tax cuts are bad news for the stock market because they lead to more government borrowing and higher deficits.
- Rising oil prices are a threat to the economy and the stock market.
- A prosperous economy means a prosperous stock market.
- High-growth economies have booming stock markets, while low-growth economies have laggard stock markets.
- Growing companies have better stock performance than companies that do not grow.
- Small stocks outperform big stocks.
- Cheap stocks outperform expensive stocks.

"To know what your fellow investors don't know, you must look anywhere but where everyone else is looking."

Although these statements are false, studies supporting them tend to enjoy wide popularity. One such study, *Valuation Ratios and the Long-Run Stock Market Outlook*, by John Y. Campbell and Robert J. Shiller, argued that high P/E ratios are a harbinger of market doom. However, to arrive at this conclusion, these authors made a number of assumptions about the composition of the P/E ratio – assumptions that are not true of the ratios that most investors use. In fact, the relationship of P/E ratios to stock prices is almost random. Long-term forecasts of market levels or stock prices are almost certain to be wrong since long-term prices depend on the long-term supply of stocks. No one knows what the long-term supply of stocks is likely to be, therefore, a prediction about future prices is little more than guesswork.

"You're most likely to suffer hindsight bias after a run of luck with an individual stock, sector, or even a broad market call you've made. Luck being the operative word."

These false beliefs undermine many investors for the simple reason that the human mind and brain evolved to deal with problems other than the stock market. Heights are dangerous in the physical world, and the analogy of market peaks to mountain peaks inspires a fear of falling. Behavioral finance researchers Daniel Kahneman and Amos Tversky have demonstrated that people are more afraid of losses than they are eager for gains.

Rather than calculate P/E ratios, investors could instead calculate the earnings yield ratio. The P/E ratio puts price over earnings; the earnings yield ratio puts earnings over price. So we could call it the E/P ratio. The E/P ratio allows investors to compare equity and bond yields directly. When the stock earnings yield exceeds the bond yield, stocks are relatively cheap – and, indeed, viewed globally, stocks are cheaper than they've been for roughly 25 years. A similarly skeptical look at the real numbers debunks the myth that a high federal deficit is bad for the stock market. In fact, high budget deficits usually precede good stock markets, while high budget surpluses tend to occur before bad markets. Remember, everything is relative. America's $423 billion deficit may look high in absolute terms, but compared to America's $13 trillion GDP, it is small potatoes: a mere 3.25%. That's why the market has been booming even though the deficit has hit record levels.

"Any advantage you have is likely temporary."

Investors who make a discipline of asking themselves which of their beliefs are false are apt to discover useful new truths.

“It’s simply not true coupon payments and dividends are a ‘safe’ way to garner income from your portfolio.”

Question Two: What Can I Understand That Others Cannot Understand?

Investors who think the unthinkable give themselves a market edge. To beat the market, individual investors must have information the rest of the market does not have. They also must understand what the rest of the market does not understand, and must look where others are not looking.

Seeing what the crowd misses is not easy or natural, neither is developing a fresh viewpoint. Human beings seem programmed to groupthink and group action, which are dangerous in the context of the stock market. Looking where others do not look does not mean consistently doing the opposite of what others do. Yes, the market will do things that most people do not expect, however, those events are not necessarily the opposite of what everyone anticipates. When everyone thinks the market will go up, it may go down – but it also may go up far beyond expectations or it may not move at all. A contrarian investor is as likely to be wrong as the crowd is likely to be wrong; doing the opposite of the crowd isn’t really all that different from following the crowd.

“Just because gold has appreciated at roughly the rate of inflation, you shouldn’t conclude gold can tell you where inflation will go. It should tell you over long time periods gold investors get pretty darned low returns – which is what you should intuitively expect from most commodities.”

Some experts cite the yield curve as a market indicator. In theory, when short-term interest rates grow higher than long-term interest rates, that is supposed to be a sign of bad times ahead for stocks. Actually, an inverted yield curve may signal a coming recession. Financial institutions cannot make much money lending long-term and, therefore, they reduce their lending. Cutbacks on lending mean cutbacks on the liquidity of the economy, which may signal a recession. However, a recession is not necessarily correlated with a bad stock market. Ironically, no single country’s yield curve matters greatly anymore because capital flows easily across national boundaries. The only yield curve which really matters is the global yield curve and it is flat.

Few people pay attention to the relationship between U.S. presidential terms and markets. Generally, the first two years of a president’s term are risky for the markets, because during these years, the president tries to pass a new legislative agenda. Many such agendas seem to involve redistribution of wealth, which means taking away from some people. The victims tend to be unhappy about this, and since no one knows precisely who the victims will be, nervousness and anxiety take their toll on the markets.

“It’s a gross generalization, but about two-thirds of the loss doesn’t happen until the back of the bear.”

Question Three: What Cognitive Illusions Are Fooling Me Now?

As almost everyone knows, the way to succeed in the markets is to buy low and sell high. Yet, as a general rule, most people do just the opposite. Human evolution has endowed people with brains that are well-suited to survival as hunter-gatherers, but not very well suited to survival in the markets. Behavioral finance researchers have shown fairly convincingly that people do not behave rationally with respect to money. Some of the more dangerous irrationalities are:

“Something else [can happen other] than what the consensus expects, but not necessarily the reverse.”

- Pride on the one hand, fear of regret on the other – Both emotions lead people to take credit for things that were not their responsibility, and to refuse credit for things that were, thereby interfering with dispassionate analysis and experiential learning.
- Excessive confidence – Most people think they are better, smarter or stronger than they are. Overconfidence may have been an asset in the Stone Age, when it led people to take risks, such as hunting huge animals with sticks and rocks, but it’s deadly in the markets.

- Confirmation bias – People tend to retain and remember evidence that supports their prejudices, and to discard evidence that challenges those fixed ideas. Confirmation bias helps support people in their beliefs, even when their beliefs are false.
- Pattern vision – Human beings see and rely on patterns, sometimes trusting patterns whose real existence is questionable. Patterns give people comfort, but investing on the basis of nonexistent patterns would be cold comfort indeed.
- Hindsight bias – People tend to attribute greater sagacity to their past decisions than those decisions merit. "I always knew…" often precedes a statement grounded in hindsight bias. A related phenomenon, "order preference," leads people to boast about the one stock they bought that did extremely well, while ignoring their less stellar choices.

"Supply and demand being the only determinants of stock pricing – and the potential to create or destroy new shares being nearly infinite – is why no correctly calculated index, size, style, country or category is better for all time."

Always keep in mind, as a rule of thumb, that the market actually intends to crash and humiliate you. When everyone agrees about something – such as a new paradigm or an infinite future for dot-coms – it's probably false. People never refer to bubbles as bubbles when they are still bubbling. Similarly, the most dangerous part of a bear market is not the beginning, but the end. The steepest falls happen as the bear matures. If you think a bear is beginning, wait a while and see if the market continues to fall. If it falls beyond 2%, wait for a correction, because you don't want to get out prematurely. Sometimes bears look like bulls and bulls look like bears.

Making It Work

To make the best use of the three questions, investors should ground their answers in factual data. Capital markets technology has advanced greatly, so you can select and benchmark indices to identify each one's relative return. Make small adjustments relative to your benchmark, but be careful about getting too far away from it. After all, you selected your benchmark because it makes sense for you, so don't simply throw it away. Once you devise an investment strategy, stay the course. Inconsistency is one of the greatest problems investors have. Remember the following rules:

"I invite you to be skeptical about everything in this book…What I don't want you to do is think I'm wrong but never prove it. That won't do you any good. It's just a waste of time. If you think I'm wrong and can show it satisfactorily with data, you haven't hurt anyone… I can take it!"

- Pick a benchmark that fits – Determine the fit based on your time frame, cash flow needs, return requirements and personal preferences (such as ethical investing concerns).
- Carefully examine your benchmark's risk and return – Look at each component stock in the benchmark index. This will help you determine which securities you should include in your portfolio, when to hold them and when to discard them.
- Diversify by selecting securities that are not correlated – Although some great investors advocate concentrating investments in certain sectors and companies, this is an extremely high-risk strategy. Diversification can help you manage risk and it does not prevent you from reaping great returns.
- Follow the rules with discipline – Your personal whims and any sudden impulses you feel to deviate from the rules will probably lead you in the wrong direction. Always ask the three fundamental questions whenever you think of straying from your deliberate, disciplined investment plan.

About The Authors

Ken Fisher has written the "Portfolio Strategy" column for *Forbes* magazine for more than two decades. He is also founder, chairman and CEO of a money management firm with more than $30 billion in assets. Jennifer Chou and Lara Hoffmans are research analysts at Fisher's company.