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Michael Edesess • Kwok L. Tsui
Carol Fabbri • George Peacock

THE 3 SIMPLE RULES OF INVESTING

WHY EVERYTHING YOU'VE
HEARD ABOUT INVESTING
IS WRONG—AND WHAT
TO DO INSTEAD

More Praise for *The 3 Simple Rules of Investing*

“This is the book that investors have needed for a long time. It empowers readers to take control of their financial lives and to tune out the propaganda from the investment industry. It becomes easy for investors to do the right things for themselves once they get rid of all the noise and follow the simple approach that the book recommends.”

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—**Richard C. J. Somerville, PhD, Professor Emeritus and Research Professor, Scripps Institution of Oceanography, University of California, San Diego**

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BK

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The 3 Simple Rules of Investing

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To our daughters, sons, and spouses:

*Hilary, Ariel, Joshua, Matthew,
Suklai, Alex, Luca, Duncan, June,
Hayley, and Mackenzie*

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CONTENTS

PREFACE ix

INTRODUCTION 1

The Simplify Wall Street Portfolio

PART I The 3 Simple Rules of Investing

RULE #1 27

Simplify Your Options

RULE #2 49

Look Only Forward

RULE #3 71

Tune Out Noise

PART II Investing's 7 Deadly Temptations

DEADLY TEMPTATION #1 75

Beat the Market

DEADLY TEMPTATION #2 95

Trust It All to Our Expertise

CONTENTS

<i>DEADLY TEMPTATION #3</i>	105
Precisely Calibrate Your Portfolio	
<i>DEADLY TEMPTATION #4</i>	119
Sleep Well at Night with Your Risk Under Control	
<i>DEADLY TEMPTATION #5</i>	135
Use the Strategies That Always Work	
<i>DEADLY TEMPTATION #6</i>	155
Do What Wealthy and Sophisticated Investors Do	
<i>DEADLY TEMPTATION #7</i>	171
Use Modern Scientific Financial Theory	
<i>EPILOGUE</i>	191
The Invisible Squeeze	
<i>Notes</i>	201
<i>Glossary</i>	209
<i>Acknowledgments</i>	221
<i>Index</i>	223
<i>About the Authors</i>	237

PREFACE

We wrote this book for all sorts of investors, from novice to experienced professional, because all of us knew—independently and at different times—that something was very wrong with the financial services industry (or simply financial industry, in this book), especially its fastest-growing sector: the securities sector and its huge investment management and advisory services arm. We wanted to explain this problem and then offer an easy-to-use solution.

Michael made an important discovery almost immediately after receiving a degree from MIT and a PhD in mathematics from Northwestern, when he joined a brokerage firm known for its use of sophisticated mathematics. He found that although the firm's representatives spoke to clients in a language laden with mathematical terms (e.g., “This fund has a low *beta* but its *alpha* is high”; “The portfolio has the highest *expected return* for its *standard deviation*”), they actually knew nothing about the mathematics and the mysterious formulas and algorithms behind their statements.

Kwok, a professor and renowned statistician whose career spanned roles at Bell Labs and several universities, knew that almost all claims of “beating the market” arose from

practices that statisticians recognize as unprofessional and downright wrong. For example, investment firms often boast about strong returns on their investment products—mutual funds and such—in their marketing materials. If you were to read the fine print in these documents, you might uncover the data “supporting” these claims. What Kwok recognized, however, is that many firms do what statisticians call *cherry-picking*: selecting from a vast body of data only those data points that back up the desired claims, and ignoring the mountain of research that disproves those claims. In other words, investment firms typically reveal only what they want investors to see.

Carol became a financial advisor following an MBA from MIT’s Sloan School of Management and a successful career in management consulting. While working for a large brokerage firm, Carol grew dissatisfied with the direct and indirect fees that the firm charged her clients, and with the lack of a formal responsibility to act in the client’s best interest. Today she continues to see complicated descriptions, fancy terminology, and opaque fee structures mislead hardworking investors, who are tirelessly saving to achieve their dreams.

George was a liberal arts major at Georgetown University who became a financial advisor. He naturally assumed that the methodologies that the industry and his employers promoted were correct. But gradually, over a 20-year period working for several of the best-respected financial firms, he began to realize that most of the foundational assumptions and “best practices” didn’t make sense. For example, increasingly over time, every firm he worked for made a key sales point out of the fact that they would “optimize” a client’s portfolio by running a

scientific asset allocation; but actually the process was nothing but GIGO: garbage in and garbage out.

Collectively, we authors have concluded that by honing marketing pitches, the financial industry has created a false framework of concepts that it conveys to clients and sells to prospects. With only a few notable exceptions, the confusing proliferation of investment services and products is of no value to any investor. A minuscule subset of the investment products and advice available—the simplest and least costly ones—are all that an investor really needs. To opt for the more complex or confusing investment vehicles and advice is merely to pay a lot for nothing.

WHO SHOULD READ THIS BOOK—AND WHY?

This book is for every individual or family who invests their savings, has a 401(k) or other tax-deferred vehicle or pension fund that is managed on their behalf, or has merely heard about investing and might do it sometime. It is also for everyone who advises or consults on investing, who manages, oversees, or administers investments, including big wheeler-dealers. To all of these readers, we'll be telling them that everything they thought they knew about investing is wrong. This declaration should not be that surprising. As many of us remember, a very big investment firm, Long-Term Capital Management, went straight down the tubes in 1998, even though it was run by Nobel laureates in economics and finance. Giant banks, with the money to hire top investment talent, also discovered in 2008 that everything they thought they knew about investing was wrong. As news stories about banking disasters around

the world continue to reveal, “experts” keep reaching this sad conclusion with depressing regularity.

The everything that you thought you knew about investing, as noted in our book title, is different depending on which sort of investor you are. Let’s see how the “why” varies with each “who.”

Novice or uninformed investors might think that frequent trading of securities will make a lot of money. Millions of investors trading furiously at their computers this very moment suffer from this delusion, believing that they’re making money—or wondering why they’re not.

Ordinary individual investors also fall victim to misconceptions fed to them and reinforced by a vast array of “helpers.” These helpers comprise a pantheon of advice givers, some of whom may not realize that they’re lending support to misconceptions: financial advisors, financial journalists, radio and television personalities, and financial academics. Even the most conscientious helpers often don’t know that many of the things they think are true about investing are, in fact, wrong. They are themselves victims of misinformation—such as the cherry-picked data and “sophisticated” math lingo we described earlier that promise low risk and high returns—and they unwittingly victimize their clients and audiences in turn.

Other types of ordinary individual investors, informed in the investment field through helpers’ counsel, their own research, or both, may believe they’re doing all the “right” things prudent and smart investors do: making sure to contribute to a 401(k) plan, rebalancing or diversifying their portfolios regularly, putting money in target-date funds, and dollar-cost averaging. Many of these practices, however, are of no use, with some even losing investor dollars.

Less ordinary, so-called sophisticated investors—such as very wealthy people, retirement plan administrators, endowment fund managers, and investment consultants—suffer from different misconceptions. Consider the individual-investor victims of Bernie Madoff—members of the socioeconomic elite. Many of them clamored for Madoff’s investment advice based on the recommendation of friends and family, fellow members of the much-touted “1%.”

Investment professionals—retirement plan and endowment fund managers, investment consultants, and so forth—often have joined a financial firm believing in its stated mission. Accepting organizational values like offering focused attention on unique client needs or helping create security for future generations, these service professionals believe—as George did at first—that they’re helping their clients. But the strategies their firms offer to make good on those values are usually riddled with misconceptions, many of which serve only to enhance the revenues of the firms. And if employed at one of those five or so investment banks that are still often described as “too big to fail,” they’re victims of another misconception: that the mathematical risk models their firm uses protect against disaster. Actually, these models are nearly worthless.

Administrators of large public pension or university endowment funds—and wealthy individuals, too—typically engage a consulting firm that may recommend investing in alternatives like hedge funds or funds-of-hedge-funds. These types of investors probably don’t realize that bloated payments for these all too often inferior alternatives heedlessly squander their money—money that was to protect heirs, finance charities, support needy university students, or secure the pensions of city employees like firefighters and teachers.

And for readers who are financial academics or investors with a technological bent and a fondness for cutting-edge ideas, the misconception dogging them is that employing a quantitative strategy, using an 18-factor mathematical model, or replicating hedge funds will make them millionaires. What they don't realize is that, again, such models aren't as effective as they sound and that the fees hidden inside these investment strategies will obliterate the return—if any—they might get.

If you recognize yourself among these types of investors, then we encourage you to read on.

PLAN OF THE BOOK

We begin our main discussion in the introduction, where we describe our recommended “Simplify Wall Street” portfolio, as well as explain why Wall Street and the mainstream financial industry don't want you to hear our advice. We'll explain how these entities make their money, and we'll clarify the terminology and numerical assumptions that we use in Part I.

Part I describes the 3 Simple Rules of Investing, with a chapter dedicated to each one. The first rule is to ignore 99.9% of all the investment alternatives offered to you by the financial industry. That's not a misprint: a huge number of investment products are available, but 99.9% of them are of no use to any investor. We'll tell you which two or three should be your mainstays, and a few more that will do no harm and could be helpful.

The second rule is to invest by looking forward. That recommendation may seem rather obvious, but it's not what most people do. Most people—and their advisors—comb through historical investment performance figures to decide how to

invest. Because that information is about as relevant to your investing future as the price of wool in Uzbekistan, you should learn to ignore the past and look only forward.

The third rule is to screen out almost everything that Wall Street and the mainstream financial and investment advice industry tell you, because almost everything they tell you is simply wrong. Tuning out the noise will free you up to pursue simpler yet more rewarding investing strategies.

Following these three rules means taking control of your own financial future. Therefore, it also involves your coming to grips with risk and uncertainty. Let this modified version of Reinhold Niebuhr's famous "Serenity Prayer" guide you: "Grant me the grace to accept with serenity what I can't foresee, the courage to plan for what I can, and the wisdom to know the difference."

Because our 3 Simple Rules don't include most of the standard recommendations from the investing community, financial media, and academia, we're going to have to explain why they don't, or you won't believe us. This is the objective of Part II, with a chapter dedicated to each of the investing world's 7 Deadly Temptations. Seductively appealing, these seven claims and recommendations have been molded over many years to sound "right," through a trial-and-error process of testing client reactions. We'll tell you why they are all wrong, meaningless, or inapplicable in the real world.

We'll begin with the temptation to beat the market. Aside from whether it makes sense as a primary goal, both theory and evidence compiled over decades of research show that beating the market is about 99.9% luck and no more than 0.1% skill.

A second and very seductive temptation is to seek wise counsel. Of course this is fine advice—wise counsel can be

very valuable. Our real concern is, is the counsel truly wise? So-called wise counsel—no matter how well intentioned it seems or how smart it sounds—may simply lead you into further temptations, temptations that are, at best, of no value and, at worst, will destroy your finances—due partly to the cost of the counsel itself.

A third temptation is to decrease risk and increase returns by submitting to a mathematically calculated asset allocation. Providers of “wise counsel” often use this temptation to entice prospects to become their clients. As we’ll show, however, asset allocation is usually a meaningless exercise (whether the professional advisor realizes it or not) that has to be laboriously rigged to produce acceptable outputs. It does nothing to improve your investment results.

A fourth temptation is to control risk by applying discipline to your investing approach. Of course you want discipline and risk control—who wouldn’t? But many falsehoods and enticements to pay extra fees can lurk in the folds of this temptation. Furthermore, the mainstream financial industry construct of “risk” is different from how average investors define the term. We’ll tell you how understanding this difference can save—and make—you money.

A fifth temptation is to do the things that always work—except that they don’t. These include activities almost always regarded as best practice, so no one doubts that they are correct, such as “Always fund your 401(k) to the max,” “Regularly rebalance your portfolio,” and “Dollar-cost averaging increases return and reduces risk.” The problem is that all of these conventional wisdoms are wrong.

A sixth temptation is to do what the most wealthy and supposedly sophisticated investors do, in hopes that financial

reward follows. This temptation often motivates people to hire (at high cost) a major brand-name investment manager or advisor. If you had the chance to have Goldman Sachs as your investment advisor, wouldn't you do it? You may not believe this, but as we'll see in Deadly Temptation #6, if you had invested with Goldman Sachs in recent years, your investments would have performed far worse than most of the alternatives.¹

And the final temptation: use modern scientific financial theory. Nothing is both more seductive and more mind-muddling than the idea that finance uses "science" and "technology." We'll show you that, if the finance industry even uses science and technology at all (which is rare), not only does it not get better results, but the science and technology themselves aren't even that sophisticated and actually are often inaccurate or wrong.

George and Michael follow the 7 Deadly Temptations with an epilogue that will show how our Simplify Wall Street investment strategy might achieve far more than greatly enhancing your own investment prospects. It could also inspire a collective movement to help reduce systemic financial risk and economic and political inequality, and help eliminate the overconcentration of power in the hands of a rich few. The global financial crisis (GFC) of 2007–2009 triggered a lot of discussion about how to regulate banking and finance to prevent more crises. But another way to change the industry is through mass action, by boycotting those investment services that are of no value to clients—namely, the vast majority of them. The more investors adopt some or all of our book's recommendations, the more they can help reduce the financial complexity that creates systemic risk and global crises.

Following our simple strategy not only benefits your own financial health, but represents a step toward healing the entire financial system—our iteration of “think globally, act locally.”

THE 3 RULES OF INVESTING WEBSITE

References to this book’s website, 3rulesofinvesting.com, appear throughout our discussion. The website goes into more detail about some topics and also shares useful tools, timely news, articles, book updates, and corrections to the book (if there are any). Also included is a page of clickable links to all the reference materials and websites that are mentioned in the book, a forum for discussion, and ways to contact us directly.

The Simplify Wall Street Portfolio

Many people refer to “Wall Street” and the “financial industry” as if these were synonymous. We’ll sometimes take that liberty, too, but in reality, many financial services firms operate far from the actual Wall Street in Lower Manhattan. In discussing the financial industry, wherever it may operate, we follow a definition described in a 2012 paper, “The Growth of Modern Finance,” by Harvard Business School professors Robin Greenwood and David Scharfstein.¹ These authors give a detailed breakdown of the U.S. financial industry:

- the securities industry (investment management and advisory services, brokerage, etc.),
- credit intermediation (loans, bank deposits, credit cards, etc.), and
- the insurance industry.

The securities industry, the fastest-growing sector, is what we mean when we use the term “financial industry” in this book.

Almost everybody gets one thing wrong about the financial industry: they think people in the financial industry know how to make money and therefore can help them make money, too. They think these folks have “magical” ways to make money with money, since most people in the financial industry make good money themselves.

Certainly some people in the financial services industry are smart and do know how to make money, but not in the way you think—not because of any particularly special or high-level knowledge requiring turbo-charged brainpower. This is the sort of fundamental fallacy we’ll explore more fully in Part II, where we discuss the “deadly temptations” common to investors of all types. The fact is, Wall Streeters and others in the financial services industry know how to make money in the most mundane way you can imagine: by charging more for their products and services than it costs to make or deliver them. In other words, they make money by generating a profit. It’s *how* they generate that profit and why that profit is so big that is the basis of our argument to resist the deadly temptations and follow our 3 Simple Rules instead.

HOW THE FINANCIAL INDUSTRY MAKES MONEY

Every business, even a “nonprofit” business, needs to earn a reasonable profit. A profit is necessary because the alternative is a loss; and if you lose money regularly, you will eventually go out of business. This fact applies whether the business is a lemonade stand selling cold drinks, a retailer peddling women’s clothes, a homeless shelter—a nonprofit—serving free meals every Friday night, or a big investment firm offering mutual funds and IRAs.

Every business also strives to make its products and/or services seem special, even unique, so that they stand out among the crowd and attract more customers than their competitors do. The financial industry has a challenge because their products (mutual funds, retirement packages, hedge funds, etc.) and services (investment advice, portfolio management, stock trading, etc.) don't easily lend themselves to appearing distinctive, let alone unique. If a product/service is hard to distinguish from that of competitors, the business must wield other strategies to still sell more and earn a profit.

To do this, the financial industry uses a common strategy: price confusion. Price confusion means pretty much what you'd think: difficulty in determining what exactly the price is. Let's say a case of paper is advertised in an e-mail promotion at the "low" price of \$29.99. It sounds like a great deal, until you read the fine print and see that the real cost is \$39.99, which you must pay now if you want your case of paper. The \$10 difference comes only if you fill out the paperwork to get a special rebate. The business hopes to confuse customers around the price so that they'll wind up spending \$39.99 and not bother submitting the rebate form.

Price confusion also occurs when the price of a product—say, a printer—is truly low, but the costs of necessities to operate that product—ink cartridges—are high. Another example is when airlines get into price wars with one another. A low-priced airfare may initially make you happy—until you pay for expensive add-ons like a checked bag or meals during the flight. Wall Street and other financial industry firms engage in this form of price confusion, too, by charging fees to conduct their business. There are so many layers of fees and so many names for them—managerial, advisory, administration,

custodial, commissions—that most people prefer to ignore their statements rather than decipher them. Another strategy is to make the price sound like much less than it is. That can be done by stating it as a small percentage of a much bigger number. If an investment advisor or manager charges you 1% of your investments, it sounds small, but your cost can add up to tens or even hundreds of thousands of dollars in a few years. The real cost, then, of financial products/services becomes confusing because these fees are usually hidden.

If you were the sellers of these investment products, and if you didn't have to clearly explain each fee, would you make it perfectly clear to your customers how much they're paying in total—especially when the amount is jaw-dropping when stated in ordinary dollars and cents?

The financial industry doesn't stop at price confusion, however. Many businesses also engage in product confusion. If they can sell you a bicycle but let you think it's a luxury limo, they can really jack up the price. Investors often can't distinguish the price from the product, or even know what the exact "product," let alone price, is. It's as though a customer is saying, "I'm paying you something in fees to buy \$X in returns." If the return is negative (a loss), that figure represents another cost, on top of the fees. It's confusing!

Greg Smith shares an example of a purposely confusing product in his book *Why I Left Goldman Sachs: A Wall Street Story*:

A Goldman quant [an investment analyst who uses a lot of math] came up with a sexy new black box with a very unsexy name. Call it Clorox.

Clorox was what is known as a “multi-asset-class momentum product,” a fancy term for “Give us your money and we’ll reallocate your funds based on historical models (taking a big markup on every reallocation).” This product was a bit like a jazzed-up version of basic portfolio management. It was like taking a baloney sandwich and offering it to a client as a Panino di Bologna. The first is worth fifty cents; the second, you can sell for eight dollars.²

Goldman could sell its “Clorox” product as a unique offering, something to distinguish the firm from its competitors and thereby attract more customers—and make greater profits.

This is why the financial industry makes so much money: not because its employees are brilliant at investing, but because the product—some form of investment (stocks, mutual funds, etc.) or advice—lends itself to spawning price and product confusion. What the financial industry is good at is increasing both product and price confusion by adding more, and more complicated, products, and keeping the total price hidden. They have succeeded in charging you the price of an artisan-crafted lunch for a baloney sandwich. That’s all.

Wall Street and the financial industry have mastered profit generation through price and product confusion to an extraordinary degree. The securities industry—that sector we’re focusing on in this book—had revenues in 2007 in the United States alone of almost \$700 billion. Of that, asset management (primarily investment advice and portfolio management) was the largest component, \$342 billion in 2007—well over four times the level in 1997.³ (It has grown further since 2007, but this is the most recent year for which we have reliable data.)

As a percentage of gross domestic product (GDP—the value of all types of products created in the United States), securities industry revenues grew more than tenfold from 1980 to 2007, from 0.24% in 1980 to 2.44% in 2007. According to Harvard researchers Greenwood and Scharfstein, this tenfold growth was due mostly to an increase in fees, specifically.

Clearly, galloping growth in the securities industry, particularly its investment advisory and investment management components (i.e., the topic of this book), has been a main reason that the financial industry as a whole has grown so large over the last 30 years. It is important to remember this fact as we proceed, and to consider the reasons for the growth.

JUSTIFYING THE MEANS—IF NOT THE ENDS

Remember the misconception that opened this chapter: that people in the financial industry know how to make money with money. Even if they did, does it follow that they can help you to make money, too, or that they will? No, it doesn't. Nevertheless, people working on Wall Street and elsewhere in the financial industry often believe that they're helping you make money, even when selling you something that is not so special in terms of either a good price or a distinctive product.

There are two reasons for this phenomenon. The first involves the “silo effect.” No single person or group in a large organization or network is wholly responsible for all the stages of a product—the way it is designed, priced, marketed, and actually comes out in practice. Different groups at a company may make these decisions separately, in their own department, or “silo.” To complicate things further, the silos seldom interact or communicate effectively with each other, so one doesn't

know what another is doing. This is the silo effect: One group makes a product they believe will help consumers, another group prices it, but no one typically looks at the larger picture and says, “If we price it this way, we’ve removed the value of the product—it’s no longer doing what it’s supposed to do.” Each decision might be thought to be in the customer’s interest, but nobody assesses the overall result to know for sure whether that winds up being true. It’s as if one team creates what they believe is a low-calorie granola bar; another team adds a lot of nuts, coconut, and chocolate; and no one notices that the bar is no longer doing what it was supposed to do. In the financial industry, there’s a long stretch between that quantitative analyst who concocted “Clorox,” for example, and the financial advisor selling that product—and a longer stretch, still, to positive returns on the investment for the customer. Each of these silos—creation, sales, and end value (returns)—operates independently of one another. It’s easy, therefore, for one group to carry on the self-delusion that they’re helping customers (and easy to absolve oneself of responsibility if things go wrong).

The second reason the financial industry believes they’re helping you is simply that when you do buy their product, they assume—not unreasonably—that you must want it. They’re engaging in a business transaction with you. When you agree to buy, they assume it’s what you want. Like any smart businesspeople interested in making money, they won’t exert themselves to point out these products’ weaknesses or to make it any clearer than they have to how much you’re really paying for them. It’s their job to market the products that will make handsome profits—to design something they can convince you to buy, to figure out how to charge you as much as they can without losing you as a client, and then to convince

you to buy it. In practice, they might use innovative means to obscure how much you're paying (i.e., price confusion).

People working in the financial industry can justify their means and comfort themselves if they need to, by assuming that you are also maximizing your profit in your own way. It's not up to them to second-guess how you do it. Even if they believe it's their job to serve their clients' best interests, they may feel they can only gauge what those interests are by what the clients are willing to buy.

We're compelled, and happy, to note that many in the financial industry don't fit the mold we've just laid out. Many people are not overly greedy, will tell you the whole truth, and will recommend products and services that *they* believe are in the *client's* best interests, even when it doesn't maximize their own profits. These providers are to be admired and applauded. This praise applies to mutual fund firms that provide simple, ultra-low-cost investment products; to financial advisors who charge transparently by the hour, day, or task, such as creating a long-term financial plan, or as a very low percentage of investment assets; to financial journalists who have a healthy skepticism of what industry sources tell them and delve to get at the truth; and to academicians who bend over backward to be clear and transparent in their writing, and who either are genuinely mathematically rigorous or eschew mathematics when it's simply unnecessary.

Because misinformation and deceptions are so endemic in the industry, however, it is difficult for investors to distinguish truths from falsehoods. This can often make it difficult for honest, ethical, and genuinely knowledgeable professionals to get through. We hope that the publication of this book will make it easier for those true professionals—the

better elements in the financial industry—to get their message across.

In the final analysis, it's not the job of people, good or bad, working in the financial industry to make you money. It's *your* job. We hope that the Simplify Wall Street portfolio that results from following our 3 Simple Rules of Investing will help you do that job successfully.

THE SIMPLIFY WALL STREET PORTFOLIO

Simplicity is the ultimate sophistication.

—LEONARDO DA VINCI

Many investors, as we've noted, are perplexed by the array of possible investment vehicles and strategies, not to mention their costs. They would be justified to lower the number of alternatives merely to reduce the price and product confusion and make it easier to make a decision, even if in the process they missed some slightly better results. But in our case, the best alternative is as plain as the nose on your face. It's the least costly, the easiest to implement, and the least risky for the benefit an investor can expect to get from it.

With this in mind, we've designed the Simplify Wall Street portfolio with just these five common investment products at its core:

- Government inflation-protected securities (in the United States, these are Treasury Inflation-Protected Securities, or TIPS)
- A low-cost total U.S. domestic equity (stock) index fund, either a mutual fund or an exchange-traded fund

(ETF—i.e., a sort of mutual fund that can be traded like stocks on an exchange)

- A low-cost total international equity index fund, either a mutual fund or an ETF
- Single-premium income annuities
- Low-cost term life insurance

In Rule #1, “Simplify Your Options,” we’ll delve into these items in greater detail and add a few more alternatives, too, but still the whole portfolio contains only 10 possible investment products.

A Portfolio for Everyone

Besides its modest number of investment vehicles and the easy-to-understand advantages of each, the Simplify Wall Street portfolio is also appealing because it works for all types of investors, no matter what their experience, knowledge base, or financial circumstances. We divide investors into four general categories:

1. Superrich individuals with multigenerational wealth and institutional investors (investors who are managing huge assets that represent, e.g., a corporation’s or state government’s retirement fund for its employees or an endowment at a university).
2. Reasonably well-off people
3. People who are getting by
4. Struggling individuals (the working poor)

The main difference between category 1—the multigenerational or institutional investor—and categories 2–4 is that the latter categories have a life cycle. That is, their investments

will accumulate for a period and then wind down as the individuals doing the investing grow older and start making withdrawals. By contrast, institutional funds—such as pension, endowment, and foundation funds—usually don't have an end point—there is no life cycle. Similarly, ultrawealthy people and families usually don't need a spend-down plan, either. They need cash flow, as institutional investors do, but they also need estate planning—specific counsel on how to preserve and pass on their wealth to future generations. Most people assume that category 1 investors, the superrich and institutional investors, are different from ordinary investors, but they can be seduced by the 7 Deadly Temptations and fall prey to investment frauds as much as everybody else. Many investors in this category were fooled by Bernie Madoff's fraudulent investing schemes, after all, and by the subprime mortgage securities that collapsed in the financial crisis in 2008. The frauds may have a more polished appearance or sales pitch and better connections, but studies show that these investors waste many billions of dollars paying for worthless investment advice and management.⁴

Reasonably well-off investors, our second category, aren't rich. They must set aside money to invest in order to make withdrawals when they need the money later, to pay for their children's college expenses and to finance their retirement. They therefore want to get the most out of their investments but also create a comfortable and secure safety net, in case investments go very badly.

Many individuals are in the third "getting by" category. These investors can barely invest enough to fund their retirement. We'll have good news and bad news for them. The good news is that they do have a good chance of building a

retirement account. The bad news is that they won't also be able to afford a secure safety net. So, in the unlikely but possible event that their investments don't succeed, getting-by investors will be either living well below their expectations or working longer than they had hoped.

Struggling investors are faring even worse than those in category 3: they're hardly getting by at all and can't afford to invest. Unfortunately, this category includes the vast majority of people on Earth, including most people in the United States. Struggling investors are living paycheck to paycheck. This vulnerable group is frequently preyed upon by predators like payday lenders who take advantage of their instability. They will have to work *and* save as much as they can, though many will have no opportunity at all to save or invest. For those few who can save some money, there are (in the United States) federal, state, and local programs that offer very generous incentives to jump-start their savings (see the box).

THE TERMINOLOGY AND CONTEXT FOR OUR PORTFOLIO

Before we move on to the 3 Simple Rules, let's define a few words and numbers, and offer some historical context, so that you understand the Simplify Wall Street portfolio even better.

Rates of Return on Investment

How much your investments gain or lose is measured as a "rate of return on investment," or simply "return." This figure is the percentage by which your investments grow every year, on average. For example, suppose you invest \$100. A year later you have \$105. Your rate of return was 5%.

INCENTIVES FOR LOW-INCOME SAVING IN THE UNITED STATES

Saver's Credit provides a federal income tax credit of up to 50% for investing.⁵ Some Individual Development Accounts (IDAs) provide as much as a 4-to-1 match.⁶ Up to \$1,000 in savings will be matched with \$4,000 if low-income individuals are able to save.

“Nominal” dollars means to economists the dollars you see in your billfold. These dollars don't change over time. “Real” dollars means something different to them—it means what you can buy with those dollars. That changes because of inflation. Similarly, the rate of return can be a “real” rate or a “nominal” rate. A *nominal* rate is the percentage rate of growth in nominal dollars. If you invest \$100 and have \$105 a year later, your nominal return was 5%. The *real* rate is the rate of growth in purchasing power—in other words, the nominal rate adjusted for inflation. For example, let's say inflation will be 2% for the next 23 years. If your nominal rate of return is 5%, then your \$1 will grow to \$3 in 23 years. But if you think you can buy three burgers with that \$3 in 23 years that are now priced at \$1 each, think again. For the *real*, inflation-adjusted rate of return, we'll need to deduct that 2% for inflation from your 5% nominal return, so the real rate of return is 3%. So, your dollar will grow to a purchasing power of only \$2, and you'll be able to eat only two burgers.

Let's now look at what the returns are likely to be in the future. Table 1a summarizes the expectations for long-term

TABLE 1A U.S. Treasury and Corporate Bond Expected Returns and Expected Inflation September 2013

	<i>Real return (R)</i>	<i>Nominal return (N)</i>	<i>Inflation (N minus R)</i>
U.S. Treasury bonds	1.5%	3.7%	2.2%
Corporate bonds	2.7%	4.9%	2.2%

Source: Real return on U.S. Treasury bonds is at http://online.wsj.com/mdc/public/page/2_3020-tips.html?mod=topnav_2_3020; nominal return is at http://online.wsj.com/mdc/public/page/2_3020-treasury.html?mod=topnav_2_3020; corporate bond nominal return is at <http://credittrends.moodys.com>; other numbers are deduced from those numbers as shown and explained in the text.

TABLE 1B Global Equities Expected Long-Term Annual Returns and High and Low Scenarios

<i>“Expected” case Nominal (Real)</i>	<i>Low historical case Nominal (Real)</i>	<i>High historical case Nominal (Real)</i>
7.2% (5.0%)	4.8% (3.2%)	13.2% (9.9%)

Source: Historical returns and real expected return from “Credit Suisse Global Investment Returns Yearbook 2012.” https://www.credit-suisse.com/investment_banking/doc/cs_global_investment_returns_yearbook.pdf. Accessed 12/27/2013. Nominal expected return obtained by adding expected inflation from Table 1A to historical real return of 5.0%.

bonds and inflation, and Table 1b summarizes the expectations for equities (*equities* means stocks).

We’ll explain how we got these numbers, but first we have to ask you to do something no one likes to do: reel in your expectations.

What History Tells Us

An endless number of investment gurus peddle unrealistic claims and aspirations. Unfortunately, these statements are not true—except in the same sense that someone actually does win the lottery. But people would like them to be true. It's one of the reasons the financial industry serves up so many shaded truths and near-lies: because they can raise clients' hopes and spirits.

A challenge today is that for almost two decades—in the 1980s and 1990s—the real return on investment in stocks was unusually high. It averaged more than 16% a year from August 1982 until the end of 1999.⁷ In the last five years of the 1990s, it averaged 25.5%. This figure is still vivid in the memories of people who will soon retire or are already retired. At that time, they came to *expect* such high returns.

These very high rates of return were in part a correction for the *poor* returns over the prior 10-year period. In 1982, at the end of that dismal time frame, the consensus outlook was bleak. Stocks' prices were so low that they implied that future corporate earnings growth rates would be *negative*. But this expectation turned out to be completely wrong. Partly due to correcting that very negative expectation, the price of stocks subsequently soared in the 1980s and 1990s. These high expectations nourished an *overcorrection* of the negative view of 1982—a bubble. (This overcorrection was partly compensated for by the poor returns of the first decade of the 2000s.) But this booming stock market led the generation who lived through it around 20 years ago to think that 15% to 25% real annual rates of return on stocks were to be *expected*. Many of them still think that, even though it's wrong.

The best estimates of future expected rates of return come from information that is *specified exactly by contract*. Such

precisely specified contracts, unfortunately, apply only to fixed-income investments, such as bonds. For example, the contract could say that the price of the bond is \$1,000, and it will pay \$40 a year in interest until maturity, when the \$1,000 principal will be returned. Hence, the expected rate of return is 4%. (This number is also called the bond's "yield to maturity," or simply its "yield.")

Expected Rates of Return on Bonds

The issuer of a bond—usually a corporation or government—guarantees you a specified stream of payments every six months (the bond's interest or "coupon") until the bond matures. When the bond matures, you'll get approximately what you originally paid for it back—the principal (unless, of course, the bond issuer defaults—that is, can't make the payments). The bond's yield to maturity is the return you get from now until it matures, if all the payments are made. We know what that rate is, because it can be calculated with certainty.

Let's start with the safest, least risky investment you can possibly make, U.S. Treasury Inflation-Protected Securities—TIPS. (We'll be saying much more about these later in the book.) At the time of this writing, 30-year TIPS (TIPS maturing in 30 years) yielded about 1.5%.⁸ This is a *real*—that is, inflation-adjusted—rate of return because the TIPS' principal value increases annually for inflation.

The *nominal* Treasury rate of return is the yield on a *non*-inflation-protected U.S. Treasury bond. At the time of this writing, the yield on a 30-year Treasury bond is about 3.7%. This is a nominal return because the bond's principal does *not* increase with inflation.

We can infer from the 3.7% *nominal* return on Treasury bonds and the 1.5% *real* return on TIPS that their difference, 2.2%, is what the issuers of the bonds and the investors who buy them expect inflation to be over the next 30 years. Of course, this doesn't mean that's what inflation *will* be; it's just their best guess right now.

Both TIPS and U.S. Treasury bonds are guaranteed by the U.S. government. That makes them extremely low-risk. Indeed, financial academics refer to them as “risk-free.” With a little more risk, you could invest in a diversified basket of U.S. domestic corporate bonds. At the time of this writing, the yields on long-term corporate bonds average about 4.9%.⁹ Hence, the “risk premium” for investing in riskier corporate bonds instead of U.S. government bonds is about 1.2% (the corporate bond yield of 4.9% less the Treasury bond rate of 3.7%).

And remember, those yields of 3.7% for 30-year Treasury bonds and 4.9% for long-term corporate bonds are *nominal* returns. If we assume 2.2% inflation, then the real rate of return on Treasury bonds is expected to be 1.5%, just like TIPS. The real return on corporate bonds is expected to be 2.7%. These numbers round off the entries in Table 1a.

Expected Rates of Return on Stocks

Stocks (also called equities) are more risky than bonds for two reasons. First, there's no contract with stocks, as there is with bonds, saying that the investor will receive any specific series of payments. Second, if the institution that issued the bond goes bankrupt, it must pay bondholders before stock owners get anything.

Because stocks are riskier than bonds, an investor will require a higher expected return to invest in stocks. The difference between the expected return on stocks and the expected return on bonds is often called the “equity risk premium.” The amount of the equity risk premium can be estimated (a better term might be “guessed at”) in various ways.¹⁰ The historical average has been about 4% to 4.5%.

The return on stocks varies quite a lot from year to year, as anyone who has invested in them knows. However, their long-term average annual returns do not vary as much when measured over long time periods such as 30 or 35 years. As we’ll see, this is the time period for which an individual’s average retirement dollar is typically invested.

Three professors from the London Business School studied the past performance of stocks in 19 developed countries.¹¹ The countries included most of the major nations of Western Europe and Northern Europe (i.e., Scandinavia) plus the United States, Canada, Australia, Japan, New Zealand, and South Africa. The results of the study showed that from 1900 to 2011, stocks of these 19 countries offered average real returns from 2% to 7% a year—Italy lowest with about 2%; Australia highest with about 7%; Germany and France about 3%; Switzerland and Norway about 4%; the United Kingdom and Finland about 5%; and the United States, Sweden, Canada, and New Zealand about 6%.¹²

These are the kinds of real returns that are realistic—moderate single-digit returns, not whopping double-digit ones. Occasionally higher or lower returns occur for a while, sometimes for a long time, but they’re not what you should expect. If you’re lucky and you’re invested in stocks, you’ll get them. But you can’t expect them, and you can’t plan on them.

The future is never predictable, but one must sometimes use numbers for planning. For those purposes, the real rates of return from 1900 to 2011 that we just cited are the best guide we have. Those real rates ranged from 2% to 7%, with a country-weighted average—a global stock return—of 5.0%.¹³ (The *nominal* country-weighted average return over the same years was 8.3%.) For our discussion in later chapters of this book, we'll use this long-term historical global average of 5.0% as our expected *real* rate of return on stocks. We won't, however, use 8.3%—the historical rate—as the expected *nominal* return. In addition, we inferred earlier that investors anticipate 2.2% inflation in the next 30 years. Hence, our assumed *nominal* return on equities will be 7.2%—the real return of 5.0% plus 2.2% inflation.

But those are all only the *expected* returns, the ones we deem most likely. A whole range of other returns are possible. We'll want to estimate how much worse or better it could get. If we consider single years, it can get much, much better—or much, much worse. The highest single-year real returns on stocks in the United States were more than +53%, which occurred in 1933 and 1954. The worst were losses of nearly 37.5%, which occurred in 1931, 1937, and 2008.

But if we look at a long time period, the variation is far less. The worst three-decade real return was +3.4%, and the worst nominal return was +4.8%. Those were in the early part of the twentieth century, from 1910 to 1940. After 1925, the worst real return was 4.5%, and the worst nominal return was 7.7%. The best 30-year returns were quite good: the best real return was 9.9%, and the best nominal return was 13.2%.

We'll use these best and worst 30-year returns (see Table 1b) as our guesstimates of the best and the worst that could

happen over 30 years. It is true that there is no guarantee whatsoever that worse (or better) could not happen, even a negative global return. As investment writer William Bernstein has said, “A long-term negative global stock return requires not merely universal inflation, but universal Armageddon.” In that event, no investment would be safe.

ONE SMALL STEP FOR THE INVESTOR, ONE GIANT LEAP FOR SOCIETY?

Given that so many on Wall Street and in the mainstream securities industry earn their gargantuan incomes thanks to the fact that you pay much more than you realize for a product that you don't understand, how will they react when we show you how to pay 1/20 or 1/40 as much for something just as good or better—and perhaps not even to them? Well, we'd expect them to fight this advice tooth and nail. They'll create every argument they can think up why we're wrong. Their standard rebuttals to sales objections already try to dispute a few of our claims, and they'll intensify their counterarguments. They have become comfortable because their customers (or their “muppets,” as Greg Smith says some of his Goldman Sachs colleagues called their clients) so far have shown few signs of truly realizing that they've been paying a lot for really very little.

The damage is greater than that, however. Investment strategies and vehicles created in the belief that they will spread out risk and increase returns actually create more risk not just for the individual investor but for the entire financial system. If hundreds of thousands of people around the world purchase shaky investment products that eventually blow up,

the financial systems in those investors' countries can collapse in the explosion. The dramatic economic downturn of 2007–2009 in the United States, for example, was in part due to investment products that were nothing more than bundles of poorly qualified (so-called subprime) mortgages, repackaged and sold as promising investments.

The sorts of investment products we've described from Wall Street and the financial industry can also concentrate power and increase economic inequality. A minuscule percentage of the population is getting both phenomenally rich and unduly powerful, in large part because the rest of the population has been seduced into paying extraordinary fees for something that they believe they need—investment products, advice, and management—but that is, in its higher-priced forms, nearly worthless. Funds thus continue to flow to ultrawealthy captains of finance from far less wealthy investors by means of opaque, complex-sounding, well-marketed, and confusingly priced investment products and services. This cycle does nothing but exacerbate economic imbalances, intensifying economic hardship for those who pay, while entrenching a financial elite that is not only too powerful but increasingly removed from and uncomprehending of the lives of the rest of society.

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