FEATURES

Can I Please Get Rich Again?

You've bought stocks touted on CNBC. You've chased last year's number one mutual fund. Now maybe it's time to stop kidding yourself and do what really works.

By Gary Belsky, April 2002 Issue Business 2.0 Magazine

Can you still make money in stocks? A fair question to ask on the second anniversary of the Nasdaq's peak, a point at which the index stood 180 percent higher than it does today. But if you still watch CNBC or read tip sheets or take calls from your broker, you already know the answer: Sure, you can get rich! Just plow your cash into one or more of the companies recommended by the experts and wait for a home run.

Or maybe not. If you've ever 1) poured hard-earned dough into an Internet stock, 2) worked for Enron, or 3) visited a roulette table, you've probably had all the expert advice you can bear. You may be ready for a more measured answer.

Which is this: Yes, more than likely, you can make money in stocks in the long run -- even if the past couple of years proved that you're not the genius investor you seemed two years ago. But it depends on a number of factors, and the only one of them you can do anything about is your own behavior: how much you save, how well you mind the unglamorous p's and q's of an intelligent investing strategy, how much you resist the temptation to do the wrong thing. And of course, there are no guarantees that your efforts will pay off anytime soon. It took the stock market 14 years, for example, to move decisively past the peak it hit in 1968, and the 2000-2001 crash was just as bad as the busts that occurred during the 1970s and early 1980s. That's why you should always have a portion of your assets in fixed-income securities like bonds or money market accounts, regardless of how optimistic you feel.

But the basic proposition of the stock market still applies: Stocks ultimately reflect the fortunes of the companies in which they represent an ownership stake. As long as the U.S. economy continues its bumpy but generally upward trajectory, stocks should eventually follow. That's what they have done for the past 70 years, and it's reasonable to think they will continue to do so in the future. You just have to make sure you don't blow the opportunity.

You see, the problem with rising markets -- especially bottle-rocket ones like the United States enjoyed in the late 1990s -- is that they give folks an unwarrantedly high opinion of their investing skills. People on Wall Street like to say that a rising tide lifts all boats, meaning that when many stocks rise, even bad stocks rise. But a better phrase is that a rising tide lifts all egos -- when many stocks rise, everyone thinks he or she is Warren Buffett. And if there's a lesson to be learned from the current market turmoil, it's that the get-rich-quick path taken by so many investors -- obsessing over financial news, hyperactively trading in stocks, chasing the latest hot fund, timing the market, relying on the advice of "experts" -- just doesn't work over time. "Investing [this way] is the triumph of hope over knowledge, reason, and experience," says Larry Swedroe, principal and director of research at investment adviser Buckingham Asset Management. "It's speculating, not investing."

As counterintuitive as it seems, the surest way to make money in the stock market is to not work very hard at it. Don't try to outsmart the market; settle for matching it. Put most of your money in an index mutual fund, which tries to do nothing more than mimic the performance of specific investment benchmarks, such as the S&P 500 or the Wilshire 5,000, and keep adding to it. Let the market's own momentum carry you upward. If history is any guide, you'll do better than most pros.

Them's fightin' words, of course, to anyone who made a mint betting on Peter Lynch or bought Intel in the late 1980s. But if you give us a few minutes to explain some basic truths of the stock market, you'll soon wonder why everyone isn't a confirmed indexer.

Truth 1: Even the pros can't beat the odds.

Here's one stat you'll never see in those alluring mutual fund ads: Over time, roughly 70 percent of funds *underperform* their relevant benchmarks -- that is, most fund shareholders would have done better if their high-paid managers had stopped reading research reports, turned off their computerized stock-picking software, bought their shareholders an index fund, and gone fishing.

But what about the other 30 percent? Aren't they proof that some people are smart enough to beat the indexes? Well, not necessarily. Werner De Bondt, a finance professor at the University of Wisconsin, says that 12.5 percent of stock mutual funds are likely to beat the average fund three years in a row, *just as a matter of chance*. Think of it this way: The odds of flipping a coin and hitting heads 10 times in a row are roughly 1 in 1,000. So if 100,000 people flip, there's an even chance that 100 of them will produce that run of 10 heads. Does that make them genius coin-flippers? Same with multiyear investment hot streaks: They may reflect nothing but luck.

And even if a winning record does indicate superior skill, there's no way of identifying those talented stock pickers in advance. Consider a study by two researchers -- Tulane University's Prem C. Jain and Joanna Shuang Wu of the University of Rochester -- who examined the performance of 294 U.S. equity mutual funds that touted their records in ads in Barron's or Money magazine. The pair looked at the returns of the funds for one year prior to the first ad and for one year after. As you'd expect, the funds' performance was stellar before the ads ran -- with returns almost 6 percent higher than those of comparable funds during that period and 1.8 percent above the S&P 500's return. But in the year after, the funds returned 0.8 percent less than their peers and almost 8 percent less than the S&P. "Anyone who says active managers can win should wear a T-shirt that says, 'I can't add,'" says Swedroe, author of *What Wall Street Doesn't Want You to Know: How You Can Build Real Wealth in Index Funds*.

Truth 2: There's no time not to invest.

Yeah, we hear you: If only you'd sold at the peak two years ago, you'd be fine now. So maybe the right thing to do is get out of the water until the tide starts rising again. But while the temptation to jump in and out of the market at just the right moments is understandable, that strategy is both costly and impossible. "Investing is like deer hunting," says Charles Ellis, author of *Winning the Loser's Game: Timeless Strategies for Successful Investing*. "You have to be there when the right moment comes, but you can never be sure when it will." (See "Timing Is Everything -- and Impossible," below.) A far better approach to dealing with today's worrisome markets is the decidedly unheroic strategy of dollar-cost averaging, whereby you invest a preset amount of money at regular intervals. That way you force yourself to get into the market without committing your whole stash at any particular moment.

If the market goes straight up while you're dollar-cost averaging, you'll pass up some gains. But in a choppy market, the math works for you. If you invest a fixed dollar amount at regular intervals, good market or bad, your average acquisition cost per share will almost always be at the low end of the fund's price range for the period during which you're investing. Why? Because you're forcing yourself to buy more shares when the price is low and fewer when the price is high. That sets you up for extra gains in a future rally and reduced losses in a downturn. Imagine, for example, that in January 2001 you'd invested $5,000 all at once in a fund that tracked the S&P 500. At the end of the year, you'd have had just $4,398, a 12 percent loss. Had you invested that money in $416 increments at the beginning of each month throughout the year, you'd have finished one of the worst years of the past decade with $4,836 -- a 3 percent loss.

Truth 3: We're our own worst enemy.

Consider this startling stat from research firm Dalbar: For the 15 years ending in 1998, the average investor trading stocks and no-load mutual funds earned a cumulative return of 148 percent. Not bad, until you realize that during the same stretch, the S&P 500 index soared *820* percent. What did investors do wrong? Too many tried to maximize returns by flitting in and out of funds in search of the next hot industry or manager: The average holding period in Dalbar's study was just three years. "People are moved by the excitement of fast-track stocks, cocktail party chatter, and what's on CNBC," says David Dreman, chief investment officer at Dreman Value management.

Even the best of us find it difficult to resist a fund manager with a hot hand or a stock with seemingly limitless growth potential. But years of superb performance by a stock or mutual fund tend to be followed by years of laggard returns. The classic whipsaw ensues: Investors leap from lackluster holdings just before they rebound, and land in "hot" funds or stocks just before they cool. Exhibit A: Morningstar, the mutual fund rater, compared stock fund returns each year (from 1987 through 1994) with results for the next one, two, and three years. True to form, funds from the three *least* popular equity categories in year one went on in the subsequent periods to beat funds from the three *most* popular categories 22 out of 24 times.

Truth 4: Small costs add up.

One crucial reason pros (and amateurs) have a hard time beating market indexes is that indexes are "friction-free" -- as mere indicators of stock market levels, they include none of the commissions or other costs associated with trading stocks. But for real-life investors, those trading costs drag down results. (See "Small but Deadly," below.) In a 1998 study, Terrance Odean and Brad M. Barber, researchers at the University of California at Davis, analyzed the records of 78,000 investors at a national discount broker, examining their stock-picking performance from February 1991 through December 1996. This remarkable project revealed that the average household in the study earned an annualized return of 17.7 percent (roughly in line with the overall market). But the 20 percent of households that traded the most -- turning over 10 percent of their portfolio each month compared with the average of 6.6 percent -- earned just 10 percent a year. One conclusion is that overconfident investors trade too often and too poorly. That's undeniably true, but another cause of the high-octane traders' poor performance is simply commissions and other trading costs.

All in all, then, trying to outsmart the market is an uphill fight. Burdened by long odds, corrosive expenses, and poor instincts, investors who pick stocks -- or pick fund managers who pick stocks -- have little chance of beating the market. There is one major consolation, however. To profit from stocks, you needn't *beat* the market, you need only *be* the market. Which brings us to ...

Truth 5: Average is best.

The idea behind investing in an index fund is this: Since you can't expect to outperform the market, you might as well guarantee you'll at least keep pace with it -- and in the process, history suggests, beat 70 percent of professional investors. Because index funds don't need high-priced investment talent to do their stock picking, their expenses (and tax bills) are the lowest in fund land: 0.55 percent of assets each year vs. 1.21 percent for the average equity fund. More important: If you invest in, say, a total U.S. market index fund -- such as Vanguard Total Stock Market Index or Fidelity Spartan Total Market Index -- your portfolio is exposed to every industry, to companies large and small, even to foreign markets. Almost every decision that costs investors money -- which is to say, almost every decision -- is off the table. The only real choice is how much to invest and what portion to keep in a money market fund or other cash equivalent.

So why doesn't everyone buy into indexing? Beyond ignorance, the main reason seems to be that it's boring. To that concern we will plead no contest, which is why we'll allow the thrill-seekers in the crowd to use a small portion of their money to pick stocks. (See "So You Wanna Roll the Dice?") Indexing *is* boring, as monotonous as the 13.4 percent annual returns you'd have earned since 1976 had you invested in the first index fund, the Vanguard S&P 500 Index. During those 26 years, roughly a third of which were flat or down, a $10,000 investment in the average actively managed fund would have risen to $141,000. The same stake in the Vanguard index fund would have increased more than 2,200 percent to $227,000.

Rich enough?