The Rewards of Lazy Investing

The Lazy Investor’s Reward
Four More Years
Raven the Chimpanzee and Other Smart Investors
First Derivative Investing
London, Paris, Bermuda, San Fran, Tahoe, Toronto

By John Mauldin

Is being lazy the secret key to riches? Can you grow your portfolio 2,000 percent with just one decision? Did I spend 432 pages and 200 footnotes [in Bull’s Eye Investing] trying to give readers the tools they need to be thoughtful, successful investors when just one page with no troublesome research would open up to them the secret of the ages? With all my study, how could I miss such wisdom?

Today we explore the problem with “single derivative” thinking. It is in my experience perhaps the single biggest mistake investors make. We enter full-tilt, no-holds-barred into the debate as to whether you should mindlessly buy and hold, or whether you should apply some more thoughtful criteria to your investments and retirement portfolios. This is one of the most critical issues with which investors have to deal. Along the way I will explode a few well-worn Wall Street myths, tell you when it will be safe to get back into the water of the S&P 500 (yes, that day will come) and give you some of the more interesting set of statistics I have come across in four years.

Four More Years

And yes, it has been four years this month since I started sending Thoughts from the Frontline to a few thousand email addresses I had acquired from readers and clients along the way, and posting it for free. The archives are at www.frontlinethoughts.com and you can read every call and prediction, good and bad. I have been rather fortunate on my calls these last four years and hope that I will be as lucky/fortunate in the future. I am grateful that the newsletter is now sent to over 1,000,000 readers. I wish to publicly thank my publisher and long-time friend, Mike Casson, for making this possible. But most of all I thank my readers for their (by and large) very kind words and support. You are the reason I write.

But of course, not everyone agrees with me, and that brings up the subject of this week’s letter. Paul Farrell wrote last week in his CBS Market Watch column:

“It was billed as a ‘debate,’ on a nationally syndicated radio show. Me, a buy-and-hold investor to the core, versus John Mauldin, author of the Bull’s-Eye Investor [sic - Hey, at least get the title right, Paul] and Millennium Wave Investments, a newsletter publisher and investment adviser ... and a guy who is totally against a buy-and-hold strategy for the coming years.”

Bill Bailey, host of the eponymous Bill Bailey Show frequently has both of us on his show. Farrell has recently written a book called “The Lazy Person’s Guide to
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Investing.” Paul himself is anything but lazy, having a law degree and a PH.D and has authored over 1,100 columns for CBS Market Watch. Bill had read both our books, and called me up to say it is somewhat confusing to read such two totally different viewpoints. What should he do with his portfolio? Would I come on with Paul and “debate” our viewpoints?

I was happy to accommodate my friend, as it sounded like an interesting way to spend an hour. I went to the internet to get the gist of Bill’s book (buy and hold index funds). The next week I found that he had written about the discussion/debate in his column. I am not terribly thin-skinned, as I get negative remarks all the time, but this offers such a delicious opportunity for educating my readers as to the folly of assumptions about past performance that I cannot resist.

As a courtesy to Paul, I actually read his book, which is the ultimate paean to buy and forget-about-it investing. There are many excellent minor points in the book, but sadly the main thrust is one of which serious investors should be wary. Lazy Investors will find it comforting, somewhat like a priest on the way to the gallows.

But to make a preliminary point about buy and hold, and before we get into too much detail about his book, let me quote a few paragraphs from a recent review of “Bull’s Eye Investing”. In the September issue of Stock Trader’s Almanac Investor, I find that Bull’s Eye Investing is one of “The Year’s Top Investment Books in the upcoming 2005 Stock Trader’s Almanac.” I am humbled, as this is quite an honor, as Yale Hirsch is one of the icons on Wall Street. He has been publishing the Almanac for 37 years. His son Jeff is taking up the mantle and is doing an excellent job.

The Almanac, published each year, is a voluminous book full of data about patterns and seasonality trends. In fact, Mr. Hirsch years ago found that some days of the week (and some months of the year) are better for stocks than others. And, remarkably, that the stock market tends to make almost all its gains during just six particular months of the year. Yale calls his discovery the “Best Six Months” strategy. The rest of the time (most years) traders would be better off putting their money in T-bills and going fishing.

This is the May-October affect. Without going into detail about the data, using decades-long periods, long term investors have been much better off “selling in May and going away” than simple buy and hold investors. Of course, some years are notable exceptions, but that seasonality is noticeable to anyone who peruses the data.

My book is about even longer term “seasonality” - the long term cycles of secular bear and secular bull markets. The evidence they exist is clear. The question in Farrell’s mind is can we use them to time entrance and exits into and out of the market?

Oh, and that review by James Altucher in Stock Traders Almanac?

“John Mauldin writes a popular email newsletter which I have been fortunate enough to receive for the past year, so when his book came out I wondered whether there
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would be anything new. Unfortunately, there’s so much new in it that I have to read it for the third time, every now and then stopping to check the extensive third-party sources and research he references in backing his claims. I don’t always agree with him on everything but this is a must-read for the investment professional and individual investors….

“In several chapters he details (and I can’t stress this enough — he DETAILS) his concerns on pension funds being underfunded, the demographics of age in the United States, the effect of a widening trade deficit on our economy and on all the economies we trade with once we start to falter (if we start to falter), and why the psychology of the average investor prevents him from taking appropriate action (i.e. right now)….

“If I were to summarize the main message of each chapter it would be: don’t believe the hype. The hype in earnings, the hype in the economy, the hype from Greenspan, the hype from those selling advice (and avoid systems-sellers if the systems return more than 10% a year, avoid the mutual funds and academics who tell you the market always goes up 6-7% a year in the long run, avoid gold bugs (but not completely) and growth stock fanatics and …) and most of all don’t believe your own hype.”

You can read the entire review and buy the book at www.stocktradersalmanac.com. Just click on the big red book on their home page, or you can read other reviews and buy it at www.Amazon.com/bullseye. And now to the main part of the letter.

In an article entitled “Bull’s Eye Investors Still Lose” Farrell misses the target, because he made some assumptions about what is in my book. I need to set the table before I serve you dinner, so let’s look at what he says. He writes:

“Why is [Mauldin] against buy-and-hold? Well a good part of the reason is he believes the market’s going nowhere for the rest of this decade, maybe longer. But, he says, with the right aggressive strategies, you can beat the market.

“Mauldin is so thoroughly convinced that if you don’t give up on a long-term buy-and-hold strategy and actively engage in alternative strategies (such as hedge funds, gold funds and trading in value stocks) you will lose a lot of money

“So, who won the debate? Nobody! In fact, nobody ever wins this debate.

“Why? Probably because 99 percent of American investors are born with buy-and-hold DNA, they are passive investors who rely on well-diversified portfolios often of low-cost index funds. They don’t have the time, money or interest in active portfolio management, nor do they trust in the market or in professional market experts.

“Meanwhile, the DNA of the other one percent, the so-called ‘Bull’s-Eye Investors,’ contains a rare overconfidence gene that pumps an ‘I-am-convinced-I-can-
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beat-the-market’ drug directly into their brains. Of course the odds are against them beating the market, but that gene contains a blocker that suppresses negative information. The brain chemistry and psychological profiles of these two types of investors are worlds apart. If you listened to a debate between Shotgun Investors and Bull’s-Eye Investor you’d think you were talking to two aliens, one from Mars, the other from Venus. They are more different than voters in blue versus red states.

“82% of all day-traders are losers

“And each type of investor is as dogmatic as the other. DNA-based ideologies control each one. Minds are locked up. Opinions already cast in concrete. The facts are totally irrelevant. Of course that was a given from the start, as I found out once again in our so-called debate. Here’s why: Just before the ‘debate’ I got some interesting new data from a Business Week article.

“Get this, most traders are losers; 82 percent of all day-traders lose money.”

Raven the Chimpanzee and Other Smart Investors

And then Farrell launches into a lengthy diatribe about how day-trading is not a good thing. Evidently some chimpanzee named Raven beat day-traders with a dart.

Farrell accurately points out that buy and hold investors would have made more than the average of the 18% of day-traders who made money in the study.

In all fairness he concludes, ‘The only people who really make money in trading are the service professionals (stock brokers, hedge-fund managers, financial advisers, etc). The pros get their commissions no matter how much investors and traders lose. Even in bear markets their ads paint a different picture, appealing to the trader’s self-sabotaging, addictive, super-confident DNA, to convince them that they (the pros) have the secret to beating the market, using buzzwords like ‘Bulls’-Eye Investing.’

“The truth is: They can’t, they don’t and they never will hit the target and beat the market. But as I found out one more time in this latest ‘debate,’ I may as well have been trying to convince Raven that eventually he too would lose, and lose big.

“In that respect, chimpanzees are superior to human traders. The trader’s DNA controls their brains; they have no choice but to chase the fantasy that they can beat the market. They are addicted to losing. The pros know this and love milking their delusional ‘winner’s fantasy’ like a cash cow.”

During the “debate,” I repeatedly pointed out I do not endorse day trading for the large majority of investors. It is a pro’s game. Bull’s Eye Investing is all about value investing. You know, Graham and Dodd, Warren Buffett and that type of crowd. If anything, I am more like decade-trading for the average investor. I just want to use value as the criteria. But Paul ignores value because for him over the long term, buy and hold
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works. Today, or 1976 or March of 2000 is a good time to start. He gives us this sample from his book (and now we get to the fun part). After singing the (justifiable) praises of Jack Bogle and the Vanguard 500 fund, he writes:

“That means, if you have been in the fund since [it began in] 1976, you’ve made a cumulative return of roughly 2,000 percent. Look at it this way: If you gave Bogle $10,000 in 1976, your investment would now be worth $200,000, including the original money. Twenty times as much as you put in. Now folks, that’s exciting news!

“And it’s even more exciting to know you would have made that kind of money if you had stopped reading the newspapers, avoided online trading, never watched CNBC...and simply stuffed your shareholder documents from Bogle’s totally boring, dull, passive index fund in a shoe box in your attic and never looked at them the past twenty-six years.”

The clear implication that the reader comes away with from this chapter and the book is that if you buy and hold this fund you will end up a winner. You can retire in 26 years with quite a tidy sum tucked away.

But how realistic is that from today’s date? Not very, unless we see a bubble almost three times as big as the last one. Let’s look at the numbers. I had my able associate Harry Ward (who just passed his final leg of the CFA exam) run some numbers for me. As near as we can figure, 26.5 years was the number from when Farrell’s book was written, so we will stick with that.

Today the S&P 500 is around 1100. Compounding and dividends into the future using historic return rates take us to 22,165 in 2030. Pretty impressive number, but not very realistic.

Let’s remember that over long periods of time the earnings of corporate America simply cannot and will not grow faster than GDP plus inflation plus dividends. Anyone who argues more optimistically has not done his homework. The research is “in the book.” Further, actual numbers shows the S&P 500 does not even do that. Much of the growth in earnings in the US comes from new companies. The S&P 500, composed of the largest of US companies, actually grows slower than the average US company. Rob Arnott and Bill Bernstein (whom Farrell quotes a lot in his book) show that there is a 2% dilution factor between expectations and reality. The fact is, stock price and dividend growth were 2% less than the actual macroeconomic growth of the country.

Let’s assume for a moment that GDP will be 3% for the next 26 years, which is pretty much what it has been for the last 26 years. We’ll also assume 3% inflation for the moment, which is slightly less than the average for the last 100 years. Dividends are now around 1.7%. Then let’s subtract the 2% dilution. You get 5.7%.


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That is an interesting number, because that is also what reported earnings have actually been growing for the last 16 years, in the midst of a huge economic growth period, so we are not being pessimistic.

Today, the core P/E ratio for the S&P 500 is 21. Using 2nd quarter core earnings as our base, we find that if the S&P 500 grows to 22,000 and change in 2030, the core P/E ratio will be a moon shot like 97.

How can this be? How could we have had such stellar performance since 1976 if such growth in the future is unrealistic? The answer lies in that “first derivative thinking” I mentioned in the opening.

First Derivative Investing

Andy Kessler sent me the galleys for his new book, Running Money, about his experiences as a hedge fund manager which I have been reading in my leisure. He talks of a concept thrown around in hedge fund circles called second derivative investing.

In physics, we are taught to think of speed as the first derivative. The second derivative would be acceleration. If you are asked the classic question, “A car is going 50 miles per hour. How long will it take to get to Hoboken from Miami?” it is pretty simple math. But if they throw in the curveball that the car is accelerating at 10 miles per hour the answer involves a much more complex equation. That would be the second derivative. But what if we add a third derivative and state that the acceleration is increasing at 10% every 39 minutes?

Don’t even think about fuel consumption, highway construction, if there are kids in the back seat, the age of the drivers, caffeine consumption, and other effects from the space time continuum, etc. It can get complex.

In this case, the first derivative is simply the price of the stock market and/or mutual fund. First derivative thinking would be simply projecting past price performance into the future. And that is what Farrell does. Now, admittedly he does not say you will get 12% compound. But he implies the market over long periods of time will grow as fast as it has in the past. You cannot beat the market, so you might as well invest in the lowest cost fund which represents the market. He contends that any other choices than index funds (and bond index funds as we will see next week!) is simply wasting your time and losing you money.

I might agree with that view for investors with few choices (as in many 401k plans) if we could make the long period of time 126 years rather than a mere 26 years. But even then I would have to admit there are some very major exceptions where active management, especially if it is value-focused, will outperform.
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Paul, while I may indeed be no smarter or adept at investing than Raven the Chimpanzee, I would politely suggest that we need to at a very minimum look at the second derivative of investing and that would be value.

The average P/E ratio for the S&P 500 since 1926 is around 15. Typically, 21-22 is in the upper end of the range with 8-11 being the lower end of the range. Over long periods of time (secular bull and bear markets) the market fluctuates around the mean. I think it is quite possible that in 2030 we may be at the end of the next bull market. Valuations, after dropping into the low teens (or lower) this decade will turn around and a long bull will commence. What will the S&P 500 be in 2030 if we are one again at a P/E of 21?

Somewhere in the neighborhood of 4800, give or take a dime. That 4800 is less than 25% of what it would be at a 12% compound rate. At 3% inflation a dollar will only be worth $.46. It will take $2.15 to buy what is worth a dollar today. That is a compound growth rate of (surprise, surprise) 5.7%. But “objective” profits in that rear view mirror may be smaller than they appear.

Your return will be less than that, because you have to pay taxes. The S&P 500, if past is prologue, will change 250-300 companies through mergers and dropping and adding companies due to growth. As the dropped and added companies are bought and sold, that will create taxes due. And don’t forget dividend distributions and capital gains for which you will have to pay taxes in the meantime.

Not to mention that even though the average return for the S&P 500 for the last century was 7.2%, the compounded return was a far more modest 4.8%. That is because when the market drops 20% it must climb 25% to get back to break even. So assuming 5.7% may be aggressive if we experience a few recessions and a bear market or two in the coming decades.

I should note that this is a very big difference in retirement lifestyles. At a 5% return we are talking the difference between $2,400 and $11,000 per year on that original $10,000.

The real reasons the S&P 500 compounded at 12% the last 26 years are two fold. First, we started with a P/E ratio of 10 at the end of 1975. Over the ensuing years we simply valued a dollars worth of earnings at a much higher rate. Perhaps not as high as the bubble levels of 1999 (over 40), but still historically quite high. As Arnott showed in another research paper, 80% of the growth of the S&P 500 was simply due to increased valuations and not to earnings growth.

Second, we had the highest period of inflation in the last century in that period. The inflation calculator at www.westegg.com/inflation (a useful thing to bookmark) shows 326% inflation for the entire period. Just the first 6 years alone was 70%.
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Are these two items likely to repeat in the next 26 years? Anything is possible, but not all things are likely. It is doubtful we aspire to a P/E of 40, let alone 97, once again in our lifetimes, and if we do, it will prove to be just as ephemeral. Say what negative things you will about the Fed, does anyone really think we will ever see sustained 10% inflation again?

And let’s not forget the Reagan tax cuts and the coming of the Digital Age, which drove the markets. There were was more going on than simple market action which made for the largest and longest period of sustained results in US history.

A Little Sleep, A Little Slumber

And that does not even take into account the third and fourth derivatives of demographics and international trade. Can we talk Muddle Through Economy? Investing is far more complex than simply buying the S&P 500 and hoping you can retire on 12% compound growth. Anyone relying upon such a fantasy will find he is working an extra ten years after his hoped for retirement date.

I am just getting wound up, and we are near the end of our time, but I will take up the “debate” next week in part two, where I will reveal that one day in the future I will also become a believer in buy and hold of the Vanguard 500 as part of a reasonable asset allocation program. But that is not this day. I think one day in the future that 8-10% compound returns (or more) will be possible. But that is not this day. It is not, as Paul suggests, part of my DNA to mindlessly chase some fantasy by trading peripatetically. I do hope to beat the markets over time, that I will readily admit to. And I think I lay out a reasonable road map in Bull’s Eye Investing. I think my book pretty well documents that path, and I hope Paul reads it. Maybe we can even make a value/absolute return investor out of him, with a little Bull’s Eye gene therapy of his investing DNA.

But I believe that by using a few facts, some logic and an eye to history that it is in fact possible to do well. But it takes more than being a lazy investor. Let’s be clear on one thing. If you are a lazy investor, you will earn the rewards of being a lazy investor. In secular bull cycles, when values are rising, when a rising tide lifts all boats, those rewards are a good thing. But when you are on the wrong side of the value curve, it is a prescription for working long past your retirement. Assuming the next few decades will be like the last few violates the first rule of investing: past performance is not indicative of future results. It is first derivative investing in a multi-dimensional world.

A little sleep, a little slumber, a little folding of the hands to sleep— so shall your poverty come on you like a prowler, and your need like an armed man. Proverbs 6:10-11. Words to the wise, indeed.

London, Paris, Bermuda, San Fran, Tahoe, Toronto

Looking at my travel schedule for the next few months makes me tired. But I must admit that I am going to some fun places, so I doubt few will feel sorry for me. Next
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week I leave for a quick hop to London to be with Absolute Return Partners and Niels Jensen and a few friends, then on to Paris with some clients and a weekend with Bill Bonner at his chateau.

The final details are on the web for Telecosm 2004, hosted by George Gilder and Steve Forbes at Lake Tahoe, Nevada on October 20-21 at www.telecosmconference.com. Telecosm 2004 has a pretty powerful line-up of speakers, especially for those interested in technology. George writes me that: “Any of your subscribers registering though the link below will receive over 80% off the conference list price of $2,995, plus qualify to register a guest for FREE (if registered before Sept. 17, 2004). http://www.gildertech.com/public/Mauldin-Subscriber-Offer-2004.htm.” Now there’s big discount just for reading this far in a free e-letter.

I will be speaking at the annual MAR Hedge Fund conference in Bermuda (maybe the largest such conference of the many in the industry). You can find out more by going to http://www.marhedge.com click on conferences.

I am speaking three times at the next Money Show event in San Francisco on September 22-24, 2004. For free registration and complete details click the link below. Don't forget to mention me and Thoughts From The Frontline, along with priority code 003336. http://www.moneyshow.com/main/main.asp?site=sfms04i&cid=default&sCode=003336

I will be in Toronto in November for a conference (details later). I will sandwich a few more quick business trips in between conferences, I am sure. December is looking quiet, though.

One of the pleasures in life is watching your kids grow up. I get to watch one of mine close up, as she has worked with me for the past five years. Tiffani is rapidly taking over the marketing and business development of my firm and will be going with Dad on this trip. She thinks this will be fun (ok, it will be), but my real agenda is to teach her how to make these trips without me to far less glamorous climes. I am fortunate.

I trust your week will be pleasant. It is my bride’s birthday this weekend, as well as that of #1 son, so we will be spending some quality family time. That is always a pleasant thing to anticipate.

Your hoping he gets upgraded a lot analyst,

John Mauldin