# Wall Street's Great Deception

*By Steven Holt Abernathy*

Steven Host Abernathy discusses investment strategies and the high return value of avoiding large portfolio losses and most critically, losses to retirement capital.

For decades, investment brokers, analysts and other members of Wall Street's largest investment houses have duped the investing public into buying what they had to sell, rather than what their clients should have.

They have churned out a continuous stream of investment advice that is not only flawed, but more often than not, antithetic to the best interests of their clients. Their strategy plays on basic human emotions of fear and greed, and is self-serving at best, corrupt at worst.

The deception has been echoed for so long and by so many in the financial community that it is rarely challenged. It has evolved into a tacit alliance between major Wall Street advertisers and the broadcast media. It is reinforced by the daily appearances of bulge bracket firm representatives, whose scripted rhetoric is proffered as market insight.

Unaware they are being fed a relentless diet of misinformation, investors ingest what they believe to be objective research and analysis, which becomes the underpinning for retirement portfolio strategy. The result is performance that consistently underperforms the markets while lining the pockets of the major brokerage firms that employ the talking heads. For many investors, following such skewed "analyses" results in erosion of their investment capital and ultimately, diminished retirement options.

A bit part of the big lie includes perfunctory research designed to lead investors into high-profit proprietary products, broker training that stresses sales techniques over investment knowledge and a compensation structure tilted towards the firm's own products—in most cases, investments the firm would never buy for its own portfolio.

The deception is sustained by promoting unrealistic performance expectations that encourage clients to stay in the markets, make more trades and buy more high-margin products. It plays upon the most basic human emotions of fear and greed, and relies on irrational behavior by investors during periods of market turmoil to attain its greatest profits. It spreads the universal gospel of risk/reward, persuading investors seeking higher returns to buy products and asset classes that put them at higher risk without compensation for that risk. Extraneous and irrelevant data, such as P/E ratios, are employed to rationalize equity opportunities when, in fact, their correlation to future stock performance is imaginary.

Writing in Financial Analysts Journal,[1] Clifford Asness notes:

> From the perspective of post-bubble 2005 after the many scandals, the observation that Wall Street is not looking out for you should be less than Earth shattering. Wall Street exists largely to sell stocks and bonds and to broker stock and bond transactions in both directions, not to make intellectually honest arguments. Similarly, the media exists to sell media. Speaking the truth may or may not be in both of their long-term interests, but investors must recognize that it is not always done. The very idea of Wall Street making impartial recommendations about its own products is a strange one. Imagine a General Motors 'transportation strategist' telling consumers, 'We kind of like cars in here, maybe some light trucks in a portfolio context …'

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## Why Aren't They Buying the Same Stocks?

The system that underpins the great deception and saps the retirement portfolios of millions of Americans is broken. It supports the lie that major Wall Street firms always put the interests of their clients first. Were that true, we would not be reading about major brokerage houses coughing up billions in exchange for not admitting they duped their most precious asset—their clients. Why is it we never read about major brokerage firms investing along side their clients?

The deception and its fallacious research reports have been used to bilk investors out of billions of dollars and robbed untold numbers of a secure retirement. Morgan Stanley was forced to pay a huge sum to investors they misled regarding the buyout of Sunbeam; Citibank paid $2 billion to settle charges they defrauded investors regarding Worldcom; and the beat goes on.

While making these recommendations to their investors, do you believe these firms had the best interest of their investors at heart? Do you think they were following the same investment advice they were giving their investors? Hardly. Goldman Sachs paid out bonuses of over a billion dollars.

## Who Would You Listen To?

As the wicked witch in "The Wiz" sang, "Don't bring me no bad news." The Wall Street psychology is based on telling investors what they want to hear: good news. Investors want to hear about attractive stocks, glamour stocks, stocks with double-digit returns. But if brokers really think these stocks are so promising, why aren't they buying them for their own portfolios?

Wall Street understands this psychology all too well and knows it's easier to sell a stock that went up yesterday than one that went down. Realizing investors would rather buy stocks already on the rise instead of doing the hard research, they take the easy path and tell their clients to buy the stock that went up four points yesterday. "Bill, you saw that GE was up four points yesterday. The reason it's going up—and will continue to go up—is because the market realizes GE is going to be worth 80 in a year versus its price of 50 today. It's already happening. You missed it yesterday; don't miss it tomorrow. Buy it now before it goes higher. If you don't, a year from now, you'll look back wish you had." How often have investors heard that line?

It's amazing. When people buy almost anything but stocks, they shop, compare and look for bargains. They clip coupons to save a couple of bucks at the grocery store. They spend an hour reading the little labels at the supermarket that compare the cost per ounce, but buy stocks on a broker recommendation without any further investigation.

Quoting again from the piece by Mr. Asness, "… what Wall Street is often really saying is, 'Ignore the price of what I am selling you.' Wall Street is in the business of selling you stocks and does not want you leaving the market. Now if a salesperson of any other purchase told you to ignore the price because 'it will all work out over the very long run.' You would run clutching your wallet."

If you went into a store to buy a dress, and the salesperson told you it was $500 yesterday but costs $575 today and is likely to cost $700 next week, would you buy it? Perhaps you might you think, "Well, I like the dress and it looks good on me, and yes, it might be $700 next week … but it might just as easily go on sale for $300 next week. I think I'll wait until it goes on sale." For some reason, people love bargains everywhere but in the stock market.

## The Better Story Wins

Wall Street knowingly gets investors anchored on lofty return expectations. They know people planning for retirement tend to overestimate future portfolio returns, so they play on that expectation by implying it is realistic. "I see no reason why we can't get you the 15-percent return on your portfolio you're thinking about," says the broker, even though historically, she knows nine percent is probably a best-case scenario and seven percent closer to reality. Buying into the 15-percent story means investors can put less into retirement savings today, keep more money for things they want now, and still have a comfortable retirement; it's music to their ears.

In over two decades of speaking to investment groups, I can't recall ever hearing a successful person say, "I am not very good at picking investments." Even those who grudgingly admit they have made some inappropriate or downright dumb investment decisions in the past think they are "above average" investors.

Successful people are confident they will be financially secure at retirement, regardless of their investment history. They believe somehow their investable assets at retirement will be sufficient to permit them to continue their current lifestyle. They speculate on portfolio growth of at least 12 to 15 percent per year. They also speculate they will have positive returns every year. "Lose money? Me?" These are dangerous assumptions.

## Looking Reality Square in the Face

It will take about $5 million to $6 million in investable liquid assets for a successful individual to retire comfortably, assuming an after-tax annual return of four percent. This excludes residences and other non-liquid assets that are often included when calculating a client's total net worth.

Someone who currently requires $10,000 monthly income will need $16,000 per month by 2018. That projection assumes a modest three-percent annual inflation. It would take at least $4 million in invested funds earning a four-percent annual tax-free return to realize $16,000 per month, and that amount does not provide for any significant increases in personal health expenses, which are likely for most people.

Over the past century, the S&P 500 index has returned roughly nine percent annually before taxes. Given the historic precedent, there's no reason to expect the average will change much in the next 100 years. Of course, investors believe they will beat the averages—after all, every one of them is smarter than the average investor—so the 15-percent annual return whopper is an easy fit for their investment egos.

But even the nine percent S&P figure is deceiving. Management fees and transaction costs immediately knock that down a couple points. Then too, few investment managers are able to match S&P returns over time, so logically, investors expecting more than six- to seven-percent annual returns after fees and expenses are kidding themselves. The IRS grabs its share, of course, as much as 35 percent. Thus, even that nine-percent annual return assumption we have been fighting to get our clients to accept is closer to the four-percent figure after fees and taxes.

I have yet to work with a single client who expects to have a losing year in the market. "The markets will have losing years, sure, but I won't." Losing years are portfolio killers; as advisors, we all know that. But try getting clients to acknowledge the possibility they will have one or more between now and retirement. No one anticipates losing years, but rare is the portfolio that avoids them.

The time needed to make up for a losing year is far longer than investors realize as well, and the portfolio must perform even better than originally assumed during the make-up period just to get back to even. This assumes the portfolio suffers no additional losing years while recuperating. That's a lot of assumptions.

All this is working against advisors trying to be candid with their clients and construct a retirement portfolio with realistic assumptions. Getting clients to accept a conservative investment strategy that strives for a consistent six-percent or seven-percent annual return while avoiding losing years can be a tough sell against the 15-percent pipedream still reverberating in their heads. The professional advisor gives the investor the hard truth: She must invest more—and spend less—to get the same result at retirement.

She goes home to think it over. She sees talking heads on television touting the latest hot stock or asset class. A commodity broker calls and suggests she put 10 percent of her portfolio into futures, implying she can enjoy the same 20- to 30-percent gains as his other clients. Her friend the real estate agent brags about the properties she owns that are now worth 100 percent more than when she bought them two years ago. The agent's new Mercedes is conspicuously parked outside.

Who does our investor listen to? Is she being overly cautious? Will she be a fool to settle for an investment strategy focused on avoiding losses instead of one pursuing big gains? Chances are she buys into one or more of the stories promising unrealistically high returns. The strategy may even work for a year or two. When the inevitable losing years occur, she faces the same agonizing decisions all over again, this time with even less investment capital available.

The advisors who put her into this situation didn't lose their commissions of course, nor did they lose their own capital. They knew better than to dump their money into the same investments they recommended to their clients—investments no more carefully researched than if chosen using a dartboard. Investors contribute to this problem by not holding advisors accountable for creating value by requiring they get paid only if they increase the net worth of those they are advising.

While our investor's retirement plans have been shattered, the advisors who swayed her to go for the aggressive strategy are making their own retirement plans on the commissions they earned for their bad advice. And grand retirement plans they are. Like politicians who, while assuring seniors that the Social Security system is safe, opt for a separate, more generous program for themselves. Advisors who pitch unrealistic returns or sell high-commission products they would never want in their own portfolios are an integral part of the great Wall Street deception.

## Where's the Wealth Creation?

Do brokerage houses spend more money studying investor behavior patterns and motivation than on true investment research? Many do; it's more profitable. When they do spend money on research and it yields solid results, the brokerage houses use it for their own proprietary portfolio until it stops working for them. It's information not shared with their investors.

Investors putting in orders at a big Wall Street firm are shooting against the firm's proprietary money. When investors are buying or selling the same stock as their brokerage firm, it's possible they are doing so *after* the firm has already bought or sold its stock—a day late and a dollar short. A review of the income statements at major brokerage houses reveals just how much money they make in proprietary investing while at times shooting against their investors' orders.

Brokers and investment advisors should be paid for creating wealth, not just making investment recommendations and managing portfolios. They should make money only when they make money for their clients. They certainly should not be paid for destroying wealth! There are firms that follow this rule, and investors would do well to seek them out.

One solution would be to compel advisors to invest their own net worth in the same investments at the same time they advise their clients to invest. In addition, the advisor should be the last one to exit an investment at the worst price. Advisors should eat their own cooking—exactly the opposite of what Wall Street does, which is to tell investors to do one thing with their money while they do something else with theirs. Why should investors follow advice that's not good enough for the brokers giving it? Yet every day, investors blindly accept and follow the advice of firms that have been fined billions of dollars for giving advice that was untrue.

## The Other Half of the Big Lie

Wall Street tells investors that they must take greater risk in order to achieve higher returns.

It's not true. It's one of the supporting pillars of the Wall Street lie structure, and helps exonerate investment advice that proves worthless. Investors *do not* have to take greater risk in order to achieve above-market rates of return on their retirement portfolios. To the contrary, they should reduce the amount of capital they have at risk, which over time, results in greater returns because it helps avoids crippling losses.

Wall Street relies on the risk/reward saw to help support the rationale for their investment advice, which leads to their most profitable products. Consider the following content from the Web sites of some of the industry's largest advisors.

From Citibank:

> Investment risk and potential reward often go hand-in-hand. Generally speaking, the greater the risk, the greater the reward potential. The lower the risk, the lower your return is likely to be.
>
> (During the 15-year period from 1981-1995) a very conservative investor, looking for safety, might have invested entirely in U.S. treasury bills, while a more aggressive investor, looking for high returns, might have invested entirely in stocks. The low-risk strategy of the conservative investor would have produced a much lower return in the long term. The aggressive investor would have done much better, but would have faced large market swings, such as the market decline in 1987. Despite the substantially greater risk, an aggressive investor who was able to hold on to this investment over the long term could have more than recouped the 1987 losses. Of course, past performance is no guarantee for future results.[2]

From Morgan Stanley:

> Risk is the chance you take of making or losing money on your investment. The greater the risk, the more you stand to gain or lose.
>
> - **Conservative.** Take only limited risk by concentrating on high-rated, fixed-income investments and some large-company stock
> - **Moderate.** Take some risks by putting money into stock, stock mutual funds, stock managed accounts, exchange traded funds, and some bonds.

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- **Speculative** or **aggressive.** Take major risks on investments with unpredictable results.[3]

From Smith Barney:

Before you make an investment, it's important to consider the possible risks and how these risks could affect your potential return. Historically, the outlook for higher returns has been accompanied by the chance for greater fluctuations in portfolio value, with the possibility of lower returns or even the loss of investment principal.[4]

The notion that higher returns can only be attained by taking higher risk is seemingly universal. Why do you suppose that concept is such a popular mantra in their advertising? I suggest one reason is when their investment advice flops, you can't say they didn't warn you. The real story behind their rationale for recommending higher-risk products may be that the big investment houses often pay lower commissions for more conservative products.

Citibank's contention that, "a conservative investment strategy produces lower returns in the long term" is questionable. Suppose you asked 100 investors which retirement portfolio they would rather have over the next 20 years: an aggressive strategy that is up 100 percent more than it is down over the two decades, or a conservative strategy that returns a consistent six percent each year. I'll bet the majority would choose the former. Look at Chart 1, which compares two such portfolios.

**Chart 1**

| Year | Return | Aggressive | Return | Conservative |
|---|---|---|---|---|
| | | **$ 100,000.00** | | **$ 100,000.00** |
| 1 | 30% | 130,000 | 6% | 106,000 |
| 2 | -15% | 110,500 | 6% | 112,360 |
| 3 | 30% | 143,650 | 6% | 119,102 |
| 4 | -15% | 122,103 | 6% | 126,248 |
| 5 | 30% | 158,733 | 6% | 133,823 |
| 6 | -15% | 134,923 | 6% | 141,852 |
| 7 | 30% | 175,400 | 6% | 150,363 |
| 8 | -15% | 149,090 | 6% | 159,385 |
| 9 | 30% | 193,817 | 6% | 168,948 |
| 10 | -15% | 164,745 | 6% | 179,085 |
| 11 | 30% | 241,168 | 6% | 189,830 |
| 12 | -15% | 182,042 | 6% | 201,220 |
| 13 | 30% | 236,656 | 6% | 213,293 |
| 14 | -15% | 201,157 | 6% | 226,090 |
| 15 | 30% | 261,505 | 6% | 239,656 |
| 16 | -15% | 222,279 | 6% | 254,035 |
| 17 | 30% | 288,962 | 6% | 269,277 |
| 18 | -15% | 245,618 | 6% | 285,433 |
| 19 | 30% | 319,304 | 6% | 302,560 |
| 20 | -15% | 271,408 | 6% | 320,713 |

The aggressive strategy does well, gaining 100 percent more in the up years than losing back in down years (up 30 percent, down 15 percent). Most portfolios do not perform with such unerring consistency, but for the purpose of comparison, let's assume these do. Let's further assume there are no catastrophic events during the two decades that cause major market eruptions, resulting in larger performance swings. The aggressive strategy appears to be a pretty good choice.

Cumulatively, it's up 300 percent and down 150 percent, an apparent gain of 150 percent over the 20-year period for a 7.5-percent average annual return. So why is it worth 18 percent less in total return than the six-percent plodder at the end of period? The losing years have taken a dreadful toll.

Losses devastate retirement portfolios, even when seemingly offset by larger gains. A portfolio's up years can outperform its down years by a substantial margin, even 100 percent, and still come up short against a conservative strategy that avoids losing years.

Now let's suppose some horrific event—a terrorist attack or other calamity—occurs, roiling the markets. The aggressive strategy takes a major hit (*see* Chart 2, Year 4). Even though the market rebounds the following year and apparently makes up the loss, the impact on the total return, even when spread over two decades, is punishing. The disparity in total return between the two portfolios is now a staggering 87 percent.

The examples illustrate several points often difficult to communicate to clients planning their retirement:

- A consistent rate of return, even though conservative, will produce more predictable returns, so retirement plans can be constructed with greater certainty.
- Even over a 20-year period, a single large loss can be too much to overcome in terms of total return.
- Smaller losses, though seemingly offset by larger gains the following year, have a cumulative effect that can eviscerate total return.
- Lost principal cannot participate in gains when the market rebounds.

**Chart 2**

| Year | Return | Aggressive | Return | Conservative |
|---|---|---|---|---|
| | | **$ 100,000.00** | | **$ 100,000.00** |
| 1 | 30% | 130,000 | 6% | 106,000 |
| 2 | -15% | 110,500 | 6% | 112,360 |
| 3 | 30% | 143,650 | 6% | 119,102 |
| 4 | -40% | 86,190 | 6% | 126,248 |
| 5 | 40% | 120,666 | 6% | 133,823 |
| 6 | -15% | 102,566 | 6% | 141,852 |
| 7 | 30% | 133,336 | 6% | 150,363 |
| 8 | -15% | 113,336 | 6% | 159,385 |
| 9 | 30% | 147,336 | 6% | 168,948 |
| 10 | -15% | 125,236 | 6% | 179,085 |
| 11 | 30% | 162,807 | 6% | 189,830 |
| 12 | -15% | 138,386 | 6% | 201,220 |
| 13 | 30% | 179,901 | 6% | 213,293 |
| 14 | -15% | 152,916 | 6% | 226,090 |
| 15 | 30% | 198,791 | 6% | 239,656 |
| 16 | -15% | 168,972 | 6% | 254,035 |
| 17 | 30% | 219,663 | 6% | 269,277 |
| 18 | -15% | 186,714 | 6% | 285,433 |
| 19 | 30% | 242,728 | 6% | 302,560 |
| 20 | -15% | 206,319 | 6% | 320,713 |

- The power of compounding is one of the most potent forces available, but it only works returns that are consistently positive.

The charts also illustrate that by improving the *certainty* of returns, portfolios will earn more over time, and the retirement planning process becomes much easier because of the predictability and consistency of the income stream. Clients are more likely to adhere to retirement plans because with no drawdowns or loss periods, the strategy is easier to live with. Much of the emotional content of future decision-making has been alleviated.

## Abandon Ship!

Logic and clear thinking can be quickly discarded when market momentum shifts, either up or down. The carefully constructed investment strategy for a retirement portfolio dissolves, replaced by fear, overreaction and decisions made under stress. Advice from well-intentioned friends and relatives abounds, as do recommendations from commission-motivated advisors. The inability to make rational choices during market upheavals is the well-documented reason why mutual fund investors rarely enjoy the same performance as their funds. They get in too late, out too soon and make too many emotional, uninformed decisions.

Make no mistake; if it's possible to lose money, it will eventually happen. Once an investor suffers a big loss, decision-making becomes even more harried and disorganized. It's bad enough to lose previously won gains, but losing a portion of a portfolio's investment capital is a disaster, and it always takes much longer to recover from down years than investors realize. Of course, they never planned to have any down years.

When big losses occur, investors may leap into an even more aggressive strategy to try to recoup losses. That means abandoning the strategy that spawned portfolio growth in the first place. Alternately, they may simply sell their equities at the worst time, convert to cash equivalents, crawl onto the sidelines and wait for the market to turn around. Sadly, when the market eventually rebounds, they are not in a position to participate in the upside because their core assets have been ravaged. In addition, by the time they become convinced the resurgent market is safe again, they have missed out on the lion's share of the rally.

## Solution: Avoid Losing Core Assets

Every retirement portfolio should have a portion of its assets in a strategy that does well in down markets. The price of this safety net is to give up some of the upside in order to avoid losses beyond a point or two during down periods. When such a strategy is in place, the tendency for investors to abandon ship when the seas get rough is reduced. Their retirement plan can continue on course, albeit at a few less knots travel speed, but under control, with less chance of running aground, and with higher returns.

Retirement plans should be supported by an investment methodology with rigorously tested risk parameters clients can live with over the long haul, through up and down cycles. No one—not even Warren Buffet—can divine which investment strategy or product will do best next year. No investment strategy works every year. Even the best and brightest of investors, hedge fund managers or corporate turnaround artists fail to make money every year. In some years, the best overall strategy simply doesn't work, or doesn't work as well as other strategies.

That does not mean, however, that the strategy should be abandoned. In most cases, the commitment to stay with a chosen strategy is more important than which strategy is selected, provided the strategy is consistent, serves the specific retirement needs and comfort level of the client, and avoids big losses. In this way, when roiling markets subside, the client's core assets will be intact and available to generate returns.

Clients need to be reminded that retirement planning and investing is a marathon, not a sprint. It's not about investment bragging rights; it's about making sure their assets are safe. The adage that higher returns can only be realized by taking higher risk is a falsehood. Higher returns can certainly be achieved by taking less risk, providing the strategy avoids the loss of critical core assets.

Despite this, investors rarely investigate the risk side of an investment strategy. The first question to ask about any investment strategy is, "How much can I lose?" not "How much can I make?"

## What to Do Today for Tomorrow?

Today's market environment is one of high valuations. Interest rates are more likely to go up than down, the dollar is dropping and the twin deficits of trade imbalance and government debt stare us in the face.

Which way is the stock market going? What about bonds? Gold? Real estate? Where do investors turn?

Wall Street and the mutual fund industry tell them, "The market is going up; you should buy stocks and now is the time to buy. You can't time the markets, so you should buy and hold for the long term. Don't worry about the short-term drops." And, oh by the way, my best advice is to buy our various mutual funds to diversify your portfolio and help protect against losses. What they don't tell the investor is the different funds hold many of the exact same companies. So much for diversification.

The folks on Wall Street are in the business of selling stocks because that's how they make their money. Whether the shares are sold directly, packaged in mutual funds, as initial public offerings (IPOs), in wrap accounts, variable annuities or in derivatives, these people want to sell you some type of equity, and preferably today. Wall Street's advice—buy what they have to sell—hasn't changed for a century. And it has been wrong about half the time. There are long periods of time when stock markets go up or sideways and long periods of time when markets go down or sideways. Unfortunately, the majority of the investing public buys into these pitches and is unaware there are better investment alternatives.

All profitable investments have certain characteristics. Investors who are unaware of these common traits are easily sidetracked from their core strategy by sexy stories of "hot" issues, and have little chance of achieving their investment objectives. One of the criteria for choosing equities should be that companies must earn a *high return on their investment capital*. Every dollar a company invests in its business should earn a high return on that capital or it should not be in business.

Coca Cola earns 15 to 20 cents on each dollar it invests in its business, an outstanding return. Albertsons, on the other hand, earns about two cents per dollar on its capital, a lousy business. The cost of capital (borrowing money) is five to six percent per year. If a business isn't earning more than the cost of capital, it's destroying value, no matter what its business. That's reality.

Remember my previous comments regarding the fallacy of using P/E ratios to evaluate stocks? The reason the P/E number is so popular is that people are innately lazy. P/E data is easily available and so, even though the data provides the wrong answer, investors rely on it for decisions. The right way to evaluate a stock is doing the hard work of tearing a company apart, unearthing the facts relating to how much the company invests into its business and its return on investment capital (ROIC). Lacking that kind of intensive, independent research, investors wouldn't know that a company like Pfizer has approximately a 30-percent ROIC while a company like International Paper has about a two-percent ROIC. Given the cost of borrowing money, a two-percent return makes no sense as an investment. I can get four percent on a government bond; why would I risk my money with International Paper or any other company when I can get an equal or better return risk-free?

These companies don't deserve to be in business, much less attract investor retirement dollars. Yet, you will find companies like this being recommended every day as part of a "growth strategy" by major brokerage houses.

I have no quarrel with a speculative growth strategy if an investor wants something that will work about 30 percent of the time. But I have yet to meet an investor who wants a strategy that *doesn't work* 70 percent of the time. It's impossible to beat the market if you are consistently in agreement with it, yet most investors succumb to the herd mentality and take their cues from market sentiment. The legendary investor Ben Graham said, "You are never right or wrong because the crowd disagrees with you; you are right or wrong because your data and reasoning are correct."

The market is wonderfully efficient; everything that is known about a stock is already included in its price. To make money consistently and avoid losses, you must have a variant opinion and you must be right.

There is no magic bullet, of course. Nothing works all the time. A value strategy, however, can produce positive returns about 70 percent of the time. Value investors experience shorter and shallower downturns, and when a down market rebounds, value investors are in a position to make greater returns.

One of the metrics used in value investing is the price to book (P/B) ratio, which measures the book value placed on a company by the market. It's calculated by dividing the current price per share by the book value per share. Companies out of favor have low P/B ratios. Research indicates that these discarded companies produce higher returns, have lower standard deviation and enjoy positive returns about 70 percent of the time over the long haul.

When a popular company is selling at 10 times book value, investors should ask themselves, "How much can I expect to earn?" The answer is not much. If you pay 10 times a company's assets, you better be getting some pretty valuable assets. That's rarely the case.

The principal reason a value strategy more often outperforms while avoiding big losses is that a company is at its lowest value when expectations for it are at their lowest level. The majority of the people running these companies are overachievers. They get up every day, go to work, try to fix what's wrong with their companies and do better. It doesn't always work, but it does in a reasonable number of instances. When you buy a company at its tangible value—its real book value—you have little risk. This is how Warren Buffet, Kirk Kerkorian and other value investors operate. They certainly don't follow the advice of the big brokerage houses!

## Investor Advice

There is a wealth of misinformation out there, much of it supported by Wall Street firms. It is designed to steer investors into strategies and products that generate commissions and fees, keep them in the market, making trades and generating profits—for Wall Street.

- Never pay someone unless they create value; you can lose your own money for free. Those unwilling to be compensated by the value they provide probably can't create any.
- Be wary of investing with anyone less wealthy than you. Verify their success.
- With any investment strategy, assess the capital at risk first, the potential for profit second.
- Contrary to what Wall Street tells you, higher returns are the result of taking less risk, not more.
- Don't invest unless the person recommending the product has more money invested in it than you do. Ask for written verification.
- Discard 15 percent per year investment return assumptions. Save more and spend less now; retire when and how you want.

### Endnotes

1 Clifford Asness, *Rubble Logic: What did we learn from the Great Stock Market Bubble?* Financial Analysts J., Nov.–Dec. 2005.

2 *www.citibank.com.*

3 *www.morganstanleyindiviual.com.*

4 *www.smithbarney.com.*