The Investor's Manifesto - by William J. Bernstein

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Absolutely my favorite author and advisor on the subject of investing. Anyone with any money to invest (or already invested) please read this book. Such clear thinking, using only facts, and using numbers not guesses. Modern portfolio theory: use passive indexes of the entire market, no speculation, no stock picking, and avoid the entire fee-sucking financial industry.

my notes

The recent economic and market debacle is a great “teachable moment”, and it may represent the best investment opportunity in a generation.

Our homes are best viewed as a consumption item, not as an investment.

Finance is a relatively circumscribed field; not that much is really known for certain. The body of knowledge that the individual investor, or even the professional, needs to master is pitifully small.

As in the depths of the Great Depression, there are now generous returns to be had for the brave, the disciplined, and the liquid. If there was ever a time to own a prudent portfolio that includes equities for the long term, it is now.

I have come to the sad conclusion that only a tiny minority will ever succeed in managing their money even tolerably well. Successful investors need four abilities.

#1 - an interest in the process

#2 - more than a bit of math horsepower, far beyond simple arithmetic and algebra, or even the ability to manipulate a spreadsheet. Mastering the basics of investment theory requires an understanding of the laws of probability and a working knowledge of statistics.

#3 - a firm grasp of financial history, from the South Sea Bubble to the Great Depression.

#4 - the emotional discipline to execute their planned strategy faithfully, come hell, high water, or the apparent end of capitalism as we know it.

I expect no more than 10 percent of the population passes muster on each of the above counts. This suggests that as few as one person in ten thousand (10 percent to the fourth power) has the full skill set.

Wall Street is littered with the bones of those who knew just what to do, but could not bring themselves to do it.

No matter how well an investor masters the theory of investing, he or she is lost if he or she lacks the ability to coolly observe extraordinary current events and say “I’ve seen this movie before, and I know how it ends.”

It never occurred to them to consider the longer span of data or the broad narrative sweep of financial history. Had they done so, they would have realized that about once every decade the wheels come completely off the machinery of the markets, and the old relationships among various kinds of investments, which they profited so mightily from, temporarily reverse with a vengeance.

The point is not to predict when such calamities can occur - that is impossible - but simply to know that they will occur from time to time, and that you should design your long-term investment strategy appropriately.

There is no greater truism in investing than this: The less you pay for an asset, the more money you are likely to make when you eventually sell it. A fall in price, under most circumstances, should lead to a higher expected return.

I emphasize three main principles:

#1 - to not be too greedy

#2 - to diversify as widely as possible

#3 - to always be wary of the investment industry

Investment return, referred to interchangeably as the “cost of capital” or the “interest rate”.

For every consumer of capital, there is, more or less, a provider of capital. That is where you, the investor - the provider of capital - come into the story. In the jargon of finance, the “cost of capital” to its consumers is exactly the same as the return to the investor, and as an investor, only by understanding the risks and rewards of the consumers of your capital can you truly understand the process.

For these three reasons - the increased possibility of loss, the difficulty of estimating future profits, and the residual nature of equity ownership - a substantial return premium should be demanded by equity owners. This is the “equity risk premium”.

Investment return and the cost of capital for business ventures are flip sides of the same coin.

In the course of earning those higher returns, your portfolio is going to lose a truckload of money from time to time.

While the 2000-2001 decline was triggered when overextended, overenthusiastic tech companies ran out of cash, the current one began when overextended, overenthusiastic consumers ran out of credit.

Diversification among different kinds of stock asset classes works well over the years and decades, but often quite poorly over weeks and months.

Investors who can earn an 8 percent annualized return will multiply their wealth tenfold over the course of 30 years.

If they have half a brain, they will care little that many days, or even years, along the way their portfolios will suffer significant losses.

In the world of finance, the only black swans are the history that investors have not read.

Investors who cannot approach the expected-return problem rationally and systematically are better off

putting half of their money under the mattress, then lighting the rest on fire and throwing it out the window.

Using historical returns to estimate future ones is an extremely dangerous exercise. It is even more dangerous to base financial planning decisions on the post-1925 database, a common zinger committed by many researchers and finance writers.

Stocks do relatively well during long periods of inflation, since companies can raise the prices of the goods and services they sell.

“Expected return,” one of the most important concepts in finance.

Stocks and bonds work the same way as the roulette table, except that the expected payoff is almost always positive. If it were not positive, no one would invest. It is still roulette, but now the investor is the house. He will never know precisely what Lady Luck will dole out, but he can make a pretty good guess of the payout, particularly over future periods of at least two decades.

U.S. Treasury securities issued with a maturity of one year or less are called “bills”; from one to 10 years, “notes”; and over 10 years, “bonds.” Notes and bonds yield an interest coupon every six months. Bills do not - rather, they are issued at a discount and redeemed at par; the difference is their “yield.”

The investor estimates the expected returns of bonds simply by starting with the interest coupon, then subtracting out the failure rate.

If 10-year corporate bonds yield 7 percent, but 5 percent of them per year fail, leaving us with the 2 percent Treasury return, this is not even-Steven. No, not even close: The corporate bonds churned our stomachs and kept us awake at night, whereas the T-note holders slept like babies.

The single most reliable indicator of fraud is the promise of high return with low risk.

With stocks, the estimation of future expected returns is the same, except that we start with the

dividend yield, then add the growth rate of those dividends.

Important rule of finance: Always think in after-inflation, or “real” terms; this avoids having to correct later for the effect of long-term inflation. In the end, focusing on real returns streamlines thinking and helps investors tune out the noise they will hear about how inflation “corrodes wealth.”

The U.S. economy grows, on average, about 3 percent per year in real terms, and total corporate profits grow along with it at roughly the same 3 percent long-term real rate.

Brokerage houses and mutual fund companies often tout the stocks of emerging-market nations, such as Brazil, Russia, India, and China (the so-called BRIC countries) because of their rapid economic growth. But beware: Share dilution, and often outright theft because of lax security laws, vaporizes a lot of this growth by the time it reaches the per-share level. For example, China’s economy has been growing at a blistering 9 percent real rate per year for more than two decades. Yet between 1993 and 2008 investors actually lost 3.3 percent per year in Chinese stocks, even with dividends reinvested. You read that right: Over this 16-year period, even before expenses, the investor in Chinese stocks lost 41.5 percent of value.4 (The loss of 3.3 percent per year before inflation calculates out to a loss of 5.7 percent per year after inflation.)

The same is also true, to a lesser extent, for the smaller “tiger” nations of East Asia: Indonesia, Korea, Malaysia, Singapore, Taiwan, and Thailand, all of which had lower equity returns than the more slowly growing economy of the United States.

Do not trust historical data - especially recent data - to estimate the future returns of stocks and bonds. Instead, rely on interest and dividend payouts and their growth/failure rates.

We can now finally estimate the real expected returns of equities. As we have already seen, in the case of the S&P 500, it is as easy as adding the approximately 2.5 percent current yield of this index to the 1.32 percent real dividend growth rate to get an expected real return of slightly less than 4 percent. This simple computation - simply adding together the dividend yield and growth rate - is known as the Gordon Equation,

Stocks have sold for as low as about seven times dividends (in 1932) and as high as 90 times (in 2000).

The market price is but a pale imitation of the real deal: the pleasure or income stream an asset delivers over time, discounted by the appropriate rate of interest for how far in the future each part of that income accrues.

A pleasure enjoyed today is almost always worth more than one enjoyed in the future. Fisher elegantly calls this the “impatience” for the item in question; it is synonymous with the rate of interest.

$r = D/P + g$ which is the Gordon Equation: Return = Dividend Yield + Growth.

What now? Many observers feel that most asset classes are at least fairly valued, and that some, such as European stocks and REITs, are downright cheap. If these observers are correct and prices mean revert up, then returns should be even higher than calculated by the Gordon Equation.

The 4 percent expected return we have just calculated for stocks is a real return. This means that the value of the portfolio after taking inflation into account - its actual purchasing power - should, on average, double every 18 years.

At the present time, many foreign equity markets yield around 5 percent. Even if their real per-share earnings do not grow at all, their real expected returns should be quite agreeable going forward: the 5 percent dividend.

In early 2009, the best real REIT return that investors could reasonably hope for was 10 percent; if substantial numbers fail over the next several years, or even if they grow more slowly than in the past, this return could be lower. (As this is being written, REIT dividend payouts are falling rapidly; if, and how much, they recover will in large part determine their future returns.)

Always favor expected returns calculated from the Gordon Equation over past returns, no matter how long of a period they cover. This goes double whenever the markets are gripped by the euphoria of a bubble, as occurred in the late 1990s, or are in the throes of a panic, as happened in 2008-2009. If one of life’s secrets is to be keep your head when all those around you are losing theirs, then the Gordon Equation is the collar that will keep it there.

The Gordon Equation currently suggests that there are better returns to be earned in both stocks and corporate bonds for the first time in more than a decade, perhaps in the range of 4 to 8 percent real returns for stocks of various kinds, and 2 percent real returns for bonds.

Investment is the deferral of present consumption for future consumption, and if anything qualifies as present consumption, it is a residence.

A home or condominium's price should increase over time. How much? The best data on house prices suggest that, after taking inflation into account, the answer is slim to none.

Home ownership is not an investment; it is exactly the opposite, a consumption item. After taking into consideration maintenance costs and taxes, you are often better off renting.

A vacation home makes little financial sense unless you are leasing it out for most of the year. So if you must have a place in the mountains or on the beach, rent, do not buy.

Are there other risk premiums to be earned by intelligent, brave, and disciplined investors? There appear to be at least two more: the "value" and "small" factors.

Good companies most often are bad stocks, and bad companies, as a group, are good stocks.

U.S. small and value stocks have expected real returns of about 5 to 6 percent; for small value stocks, which have both risk factors, about 6 to 8 percent.

At a 2 percent withdrawal rate, your nest egg will survive all but catastrophic institutional and military collapse; at 3 percent, you are probably safe; at 4 percent, you are taking real chances; and at 5 percent and beyond, you should consider annuitizing most, if not all, of your nest egg.

For every seller there is a buyer, and vice versa. All that changes is the price at which market transactions occur. When the news or sentiment about a stock improves, the price must rise to the point where eager buyers can induce the stock's holders to part with it. When news or sentiment about a

given stock deteriorates, the price must fall to the point where potential buyers become convinced that they will be adequately compensated for the purchase.

Few should own an all-stock portfolio.

Always consider Pascal's Wager: What happens to my portfolio - and to my future - if my assumptions are wrong?

Suppose they go all-in with stocks and they are wrong. Then they are ruined. Wise investors hedge their bets with a large amount of bonds, since the consequences of being wrong with this choice are not nearly as dire as being wrong with an all-stock portfolio.

The heart of the investing process: The goal is not to maximize the chances of getting rich, but rather to simultaneously allow for a comfortable retirement and to minimize the odds of dying poor.

The reason why 90 percent of investors and fund managers cannot pick stocks is simple: Whenever you buy or sell a stock or bond, there is someone on the other side of that trade, and that someone most likely has a name like Goldman Sachs, PIMCO, or Warren Buffett. There is even something worse than trading with Buffett, and that is trading with a top executive of the company whose stock you are buying or selling, and who likely knows more about its condition and prospects than even the smartest and best-informed security analyst. Trading individual stocks is like playing tennis against an invisible opponent; what you don't realize is that you are volleying with the Williams sisters.

"Efficient Market Hypothesis" (EMH) which states, more or less, that all known information about a security has already been factored into its price. This has two implications for investors: First, stock picking is futile, to say nothing of expensive, and second, stock prices move only in response to new information - that is, surprises. Since surprises are by definition unexpected, stocks, and the stock market overall, move in a purely random pattern.

The implications of the EMH for the investor could not be clearer: Do not try to time the market, and do not try to pick stocks or fund managers.

Mr. Buffett is not so much a money manager as a businessman; when he buys a company, he moves

into a metaphorical corner office and helps manage it. Over the decade ending December 2008, his holding company, Berkshire Hathaway, has returned an annualized +3.27 percent. A respectable performance compared to the S&P 500's -1.38 percent, but remember, Mr. Buffett is a value investor, and while he beat the passively managed DFA Large Value Fund, which returned +2.15 percent, for the period, he lagged the DFA Small Value Fund, which returned +7.55 percent.

"indexed" and "passively managed." These are not quite the same. The former means that a fund buys all of the stocks in an index, such as the S&P 500, whose composition is determined by a committee within Standard & Poor's Inc. Once each year, this committee replaces several of the 500 companies in the index; so too must any S&P 500 index fund.

From the index fund perspective, this is a messy and somewhat expensive process, since funds following the S&P 500 must all scramble at the same time to sell the stocks exiting the index and buy the ones entering it.

The Russell 2000 index has an even more severe problem, since there is no mystery about the selection process, and speculators can easily predict which companies are going to be added and dropped on the changeover date. Just before this, these speculators will buy up the added companies and sell the deleted ones, bidding up and down their prices, respectively. This "front-running" dearly costs index funds tied to the Russell 2000.

By contrast, a "passively managed" fund essentially creates its own private index, specifically designed to keep turnover to a bare minimum. DFA uses this approach exclusively, then takes it one step further by purchasing stocks meeting its selection criteria that typically involve total market capitalization and the book value of the company's assets. After DFA has defined the list of stocks it can own, it proceeds to buy only those that can be transacted cheaply, thus preventing speculators from "stepping in front of" their purchases.

Other fund companies solve the "indexing problem" by using less-popular indexes; Vanguard, after a royalties dispute with S&P, switched most of its index funds over to the Morgan Stanley Capital Indexes (MSCI) system, which relatively few other index funds use.

Fund companies can also employ a "total market" index that has almost no turnover. The most popular of these is the Wilshire 5000. This index, which originally contained the 5,000 largest U.S. companies, now encompasses 6,700 names and essentially owns the entire universe of domestic stocks.

In taxable accounts, active management incurs an additional penalty: High portfolio turnover realizes capital gains on which the shareholder must pay taxes.

There is nothing magical about passive and indexed investing; any active manager who charges low fees, is highly diversified, and keeps stock turnover to a bare minimum should provide value to his or her investors.

During periods of extreme economic or political turbulence, risks will seem high. This will depress the prices of both stocks and risky bonds and thus raise their future returns. Stocks and risky bonds bought at such times generally earn the highest long-term returns; stocks and risky bonds bought in times of calm and optimism generally earn the lowest long-term returns.

Understand four things: save as much as you can, make sure you have enough liquid taxable assets for emergencies, diversify widely, and do so with passive or index funds.

Always remember the textbook definition of investment: the deferral of current consumption for future consumption. If you cannot defer current consumption, you will die poor, even if you are possessed of Warren-Buffett-like investment acumen.

Save as much as you can, and do not stop saving until you die.

This book most definitely does not deal in detail with money needed in less than five years, such as saving for a house down payment. Here, the play book is very thin: Keep such funds in the safest, short-duration vehicles as possible.

Yes, picking a small number of stocks increases your chances of getting rich, but as we just learned, it also increases your chances of getting poor.

By buying and holding the entire market through a passively managed or indexed mutual fund, you guarantee that you will own all of the winning companies and thus get all of the market return. True, you will own all of the losers as well, but that is not as important; the most that can vanish with any one stock is 100 percent of its purchase value, whereas the winners can easily make 1,000 percent, and

exceptionally 10,000 percent, inside of a decade or two. Miss just one or two of these winning stocks, and your entire portfolio will suffer.

The Gordon Equation for U.S. stocks in 2009: The expected return is currently a 2.5 percent yield plus the 1.32 percent historical dividend growth rate. Thus, the ongoing dividend stream, not its expected growth, provides the lion's share of return.

Question: If you had your own choice, which would you prefer?

Choice A: Stocks go up by quite a lot - and stay up for many years.

Choice B: Stocks go down by quite a lot - and stay down for many years.

This is a trick question, of course. While most investors would pick choice A, the long-term investor should clearly prefer choice B.

Just as we buy cows for their milk and hens for their eggs, we buy stocks for their current and future dividends. If you ran a dairy, wouldn't you prefer to have cow prices low when you were buying, so you could get more gallons of milk for your investment in cows?

The conventional wisdom that young people should invest more aggressively than older individuals is quite correct.

Younger investors should own a higher portion of stocks because they have the ability to apply their regular savings to the markets at depressed prices. More precisely, young investors possess more "human capital" than financial capital; that is, their total future earnings dwarf their savings and investments.

Since young workers can be said to be the owners of a huge bond-like asset, their human capital, they can hold most, if not all, of their investment capital as stocks. Or so the theory goes.

Vanguard: the Total World Stock Index Fund. I do not recommend it, however. The 44/56 United States/foreign split of this fund, and of its underlying index, is too foreign-heavy for my taste for three reasons.

First, unless you are living abroad, you are going to be spending mainly dollars in retirement, and the foreign stocks will expose you to the risk of depreciation of the euro, yen, pound, and other foreign currencies.

Second, not only are foreign stocks riskier than U.S. stocks, they are also more expensive to own. It costs more to transact abroad, and many foreign governments tax stock dividends; although you can recover this cost in a taxable account through the foreign tax credit on your U.S. tax return, you cannot do so in a retirement account.

Last, the fund's fees are higher than they need to be, uncharacteristic of a Vanguard offering. At a 0.50 percent expense ratio plus a 0.25 percent purchase fee, an investor can separately buy its components - the United States and international stock markets - much more cheaply.

Investors can occasionally lose return with rebalancing, as would have occurred in the 1990s with Japanese and U.S. stocks, when the former went nearly straight down, and the latter went nearly straight up. In that case, the investor would have been continually selling what was the best future performer and buying the worst future performer. These caveats aside, over the long haul portfolio rebalancing, on average, adds value and certainly reduces risk, taking money off the table when a given asset class, or stocks in general, are on a tear and become overvalued.

REITs. How much? Probably no more than 10 percent of the equity allocation: 6 percent overall of a 60/40 portfolio, for example.

Tease apart the foreign stocks into those of developed nations and those of emerging-market nations, which often have very different returns.

Consider adding some more risk premiums by increasing exposure to value stocks and to small stocks by dividing the equity asset classes into four corners: large market, small market, large value, and small value.

Ignore the large growth and small growth categories, which have lower expected returns.

If you have a large portfolio, in excess of $250,000-$500,000, and you can handle the complexity, then you might want to split your domestic and foreign developed market allocation into a small- and value-weighted "four corners portfolio".

Commodities futures: Two things are wrong with this asset class. First, its future returns will likely be low - certainly much lower than they have been in the past; commodities are what I call an “asset class du jour,” on everyone’s financial lips. This is a real warning sign, since when everyone owns something, few buyers may be left to push up the price. Second, I just do not trust any of the commodities funds, or the companies offering them.

The stocks of gold, silver, and platinum mining companies provide much of the same diversification benefits as commodities futures. I am less enthusiastic about them now than I was a few years ago for two reasons. First, my old favorite in this area, the Vanguard Precious Metals and Mining Fund, has broadened its charter to invest in companies that mine base metals (mainly aluminum, copper, and lead) and other natural resources, and this significantly decreases its diversification value. Second, gold and gold stocks have also become an asset class du jour, with high recent returns and a good deal of publicity. Unless you are going on the lam, buying gold bullion itself, gold coins, or an ETF that invests in them, is rarely a good idea. The long-term, real return of the yellow metal itself is zero - an ounce of it bought a fine men’s suit in Shakespeare’s time, and still does today. In addition, gold yields no dividend and incurs storage costs.

Another asset class worthy of consideration is international REITs - property companies in Europe, Asia, and Australia. Like U.S. REITs, they have suffered recent massive price falls, and consequently yield dividends in excess of 8 percent. They may also offer even more diversification than their domestic cousins. Their only drawback is that they are only available in passive funds to independent small investors in ETF form, and thus incur commissions and spreads. Since this asset class should not constitute more than a few percent of anyone’s assets, I do not recommend including it in a portfolio unless its size is at least several hundred thousand dollars, and you can tolerate a highly complex mix of assets.

In every field of human endeavor, whether it is flying, medicine, or armed combat, this reflexive/reflective split cleaves the world into amateurs and professionals, the former driven by their emotions, the latter by calculation and logic. Investors also need to master their emotions.

Nothing is more likely to make you poor than your own emotions; nothing is more likely to save your finances than learning how to use cool, dispassionate reason to hold these emotions in check.

"Druggy LaRoche Pharmaceuticals has just come out with a world-beating antibiotic, threeblindmycin. My patients love it, and I think it’s the next Viagra. I’m buying as much of the stock as I can get my hands on. Discounted cash flow? Intrinsic value versus current stock price? Don’t bother me with silly details." The financial institutions on the other side of his stock purchases, naturally, have done the hard math and have decided to sell their Druggy LaRoche stock to our story-telling physician.

Bonds of all stripes - except everybody's current favorite, Treasury securities - should also do just fine, as long as the investor keeps maturities relatively short (less than five years) to mitigate the risk of unexpected high inflation.

Learn to automatically mistrust simple narrative explanations of complex economic or financial events.

Popular finance books provide an excellent barometer of uninformed narrative-borne public sentiment, since ambitious financial authors tend to pander to it.

Why folks bought IPOs: It is so much more fun taking a chance on finding the next Amazon.com or Microsoft than owning a doggy industrial company. In short, IPOs are the investment equivalent of a lottery ticket, with high entertainment value and low investment returns.

If you want excitement in your life, it is far safer and cheaper to take up skydiving than to seek it in your investment portfolio.

The more public visibility a company has, and the more well-known and entertaining its story, the lower its future returns are likely to be.

Because it arises from our fast-moving limbic system, fear is also a short-term phenomenon. It makes little sense that we should care about a bad day or a bad year in the stock market if it provides us with good long-term returns. But because of the importance of our limbic systems, we care - very, very much - about short-term losses. We cannot help it: That is the way we are hardwired.

Between 1929 and 2008, the Dow Jones Industrial Average rose 51.6 percent of days and fell 48.4 percent of days. If one day of losses offsets two days of gains in our psyches, then on average we would feel horrible, since the number of gaining and losing days is nearly equal.

Only when we check our portfolios less than once per year do we finally clear the grim psychological two-to-one hurdle.

The same thing that is true about individual companies and their stocks is also true of the economies and stock markets of entire nations. When you invest abroad, should you not favor those economies that are growing most rapidly? Actually, no. It turns out that this naive strategy will cost you plenty. For example, in Chapter 2 we saw that, since 1993, China has had one of the world's highest economic growth rates - at times exceeding 10 percent per year. Yet between 1993 and 2008, its stock market has lost 3.3 percent per year. We also have already learned that, to a lesser degree, the same is true for the other great economic success stories of the past few decades, the Asian tigers - Korea, Singapore, Malaysia, Indonesia, Taiwan, and Thailand - which since 1988 have all had lower returns than in the low-growth United States.

By contrast, no major nation has seen its relative economic and geopolitical position fall farther during the twentieth century than the United Kingdom. In 1900, Britannia not only ruled the waves, but the world's financial markets as well. In 2000, by contrast, it was little more than an open-air theme park playing second fiddle to the American hegemon. Once again, this had no impact on British equity returns, which were among the world's highest during the twentieth century.

Nations with the most rapidly growing economies often have the lowest stock returns.

In many developing markets, governments do not protect shareholders from the rapacity of management as well as in nations with more established legal systems. In other words, in these countries, management and controlling shareholders find it disturbingly easy to loot a company.

Nothing lasts forever: More often than not, recent extraordinary economic and financial events tend to reverse.

In an environment filled with incredibly smart, hard-working, and well-informed participants, the smartest trading strategy is not to trade at all.

Those suffering from major depression often have the most accurate self-assessments of their own abilities.

We require a certain amount of self-delusion in order to maintain our self-esteem.

Lusting after glamorous investments can damage your finances at least as much as hankering after a sexual partner, car, or house that you cannot afford.

The rich would be far better off investing with the hoi polloi in plain-vanilla, low-cost index funds.

The reason that “guru” is such a popular word is because “charlatan” is so hard to spell.

In recent years, the darlings of the story-telling crowd have been commodities funds and BRIC (Brazil, Russia, India, and China) country stocks, with disastrous results for those who read and listened to their claptrap.

If you do feel compelled to seek excitement in finance - and I do not recommend it - hive off a small portion of your portfolio with which to amuse yourself. Segregate this account, which should be no larger than 10 percent of your nest egg, from the rest of your portfolio, and never add to it. When it is gone, it is gone, and hopefully with it the thrill of stock picking.

Most grizzled veterans will tell you that the best purchases are often made when they feel they are about to throw up.

Unglamorous, slowly growing countries are often great markets; avoid making the classic mistake of conflating a rapidly growing economy with high equity returns.

Dare to be dull.

The prudent investor treats almost the entirety of the financial industrial landscape as an urban combat zone. This means any stock broker or full-service brokerage firm, any newsletter, any advisor who purchases individual securities, any hedge fund. Most mutual fund companies spew more toxic waste into the investment environment than a third-world refinery. Most financial advisors cannot invest their way out a paper bag. Who can you trust? Almost no one.

Most seek employment at brokerage houses, hedge funds, and mutual funds for the same reason Willie Sutton supposedly offered for robbing banks: “Because that’s where the money is.” Consequently, you should extend an extra degree of caution to anyone who wants to manage your finances.

The message of the preceding pages could not be clearer: Do not come anywhere near a stock broker or a brokerage firm.

Fund companies publish their fees and expenses in fund prospectuses and regular reports. They do not publish their transactional costs, but these can be estimated by looking at the level of turnover, the size of the fund, and the size of the companies they own, all of which are available. Since stock mutual funds lose about 0.1 percent of return for every 10 percent of turnover, the lower the turnover, the better.

The ownership structure of any financial services company ultimately determines just how well it serves its shareholders in the long run.

Do not invest with any mutual fund family that is owned by a publicly traded parent company.

Fidelity offers very low-priced, passively managed funds. They are so low-priced, in fact, that they serve as loss leaders, designed to get you into the store to buy its more expensive funds. As long as you keep to the discount rack, you should do well there.

Barclays, whose iShares series of exchange-traded funds (ETFs) are the leaders in this field. I am not wild about ETFs, but they do offer small investors indexed products in more esoteric asset classes that are not covered by Vanguard and Fidelity. As this is being written, unfortunately, iShares has just been purchased by BlackRock, thus clouding its future.

A 25-year-old should be saving at least 10 percent of his or her salary, this means that a 45-year-old will need to save nearly half of his or her salary.

The commission and spread costs incurred by ETFs will quickly erode their minuscule expense

advantage.

I do not trust most of the ETF providers to support these products over the very long term; all except Vanguard are publicly traded entities.

There are a few instances in which an ETF does make sense. The first is the iShares EAFE (international) value ETF, for which Vanguard offers no corresponding index/passive mutual fund. The second is the Vanguard All-World ex-U.S. Small-Cap ETF, which does not charge the 0.75 percent purchase fee levied on the investor-class shares and also carries a much lower expense ratio (0.38 versus 0.60 percent). The third would be the iShares international REIT fund (IFGL), for which there is no equivalent open-end fund available to most small investors.

I normally recommend a healthy dollop of short-term Treasury notes in place of cash, but Treasury yields are currently so low that it is better to put the funds in a money market account until short-term Treasury yields rise above 3 to 4 percent.

How does Taxable Ted deploy the proceeds of the sale of his company, which are currently in cash? This can be done in at least two different ways. The first would be a simple lump sum deployment, in which he purchases all of his stock and bond positions at once. At current stock valuations, this might be a reasonable thing to do. Alternatively, Ted might set up a value averaging path for the risky stock assets in his proposed portfolio over the next several years. A compromise between the two techniques would be to invest the first half of his stock allocation right away, then value average the rest.

The excess returns generated by rebalancing are not large, usually no greater than 1 percent per year, which is much smaller than the capital gains taxes you will realize on most sales. So purely from a returns point of view, you should never sell stocks to rebalance inside a taxable portfolio. Buying is fine, of course, and you can also use fund distributions - the capital gains, dividends, and interest the funds throw off - to rebalance as well. At some point, however, some selling is advisable to control risk. If you start with a 50/50 portfolio and a prolonged bull market takes your portfolio to 65/35, or even 75/25, then something needs to be done.

How often should you rebalance? The answer is relatively infrequently.

Rebalance your portfolio approximately once every few years; more than once per year is probably too often. In taxable portfolios, do so even less frequently.

One more advantage of an indexed/passive approach to investing. When an index fund does terribly, it is because that asset class has done terribly, which usually means that it has gotten cheaper. In turn, this usually means that its expected future returns have gone up, and that the investor can buy some more of the fund with a reasonably clean conscience. On the other hand, when an actively managed fund does terribly, the possibility that the poor performance is due to the manager's lack of skill gnaws at your self-confidence: Should you really be buying more of a fund run by a possibly incompetent manager? Did you make the wrong choice in the first place? Quite often, such poor performance is due to some combination of bad luck and poor asset-class performance. This may lead to the wrong decision: firing the fund manager just as his or her asset class is about to turn around or his or her luck is about to change. In short, indexing your investments means never having to say you're sorry.

Rebalancing can lose as well as gain return. Is there any reason to believe that, on average, rebalancing will help more than hurt? Not if we believe that market movements are random. After all, we rebalance with the hope that an asset with past higher/lower than average returns will have future lower/ higher than average returns. Is this actually true? Probably. Recall that over short periods of time asset classes demonstrate momentum, but that over periods longer than a year, they tend to mean-revert.

I recommend that beginners stick to rebalancing by the calendar once every few years or so. If at some point you do decide to switch to the threshold technique, you will need to develop individual rebalancing parameters that are not only asset-class specific, but also portfolio-specific as well. Threshold rebalancing for most practitioners tends to be a work in progress. Rebalancing a given asset class too often or too infrequently is usually a signal to adjust the threshold up or down, respectively.

RECOMMENDED READING:

Common Sense on Mutual Funds, Fully Updated 10th Anniversary Edition (John Wiley & Sons, 2009) still provides the best roadmap through this jungle.

The dean of American financial writers, James Grant.

Jason Zweig - Your Money and Your Brain

One of investment management’s great sages, Charley Ellis.