

days without seeing the market ticker tape on the scoreboard. The latest on the Dow? That's nothing. Today, you can have reports on the FTSE, the Dax, and the Hang Seng streamed to your cell phone or BlackBerry, along with up-to-the-instant reports on a government that just fell in Asia or an oil field on fire in the Middle East.

### Expert Help Is No Help at All

The reports look serious. The data sound rational, precise, scientific. But in fact, it's all geared to the emotions. It's aimed at persuading you that the market is dangerous, tricky, sneaky, wild, and unpredictable, and that you're going to need expert help if you're to make money in the market at all.

But, of course, as we've seen—as the facts make abundantly clear—the market is anything but dangerous, tricky, sneaky, wild, and unpredictable. Over the long term, it is, instead, as predictable as a sunrise, as straightforward as a Swiss train timetable. And as we will also see, it simply isn't true that you need expert help to make money in the market.

That, in fact, is the other dirty little secret of investing. Pundits like the Jim Cramers of this world, investment advisors like me, brokers, and others involved in the financial markets would like the public to believe that making money in the market takes a lot of hard work, and that we alone—thanks to our education, training, native intelligence, and intuition—have a patent on what it takes. But it just isn't so.

It has been shown conclusively<sup>1</sup> that, as far as the last 50 years of stock market investing is concerned, someone with two hours of training who invested in the S&P 500 index—and took no further action on the portfolio—would have performed better than the average professional investor with a Ph.D. in economics or an MBA in finance. You would not want someone with two hours of medical training to perform open-heart surgery on you, but you would honestly do as well as a professional in the stock market, if not better, if you eschewed the so-called hard work of investment management.

But the noise keeps insisting that the market is scary and slippery, and that it takes trained experts to succeed in it, and it does so by the

simple expedient of targeting your emotions, activating your money madness, and stirring your money monster to action. “Quick!” the noise is telling you: “React!”—to the merger or the election results or the subprime credit crisis or whatever bit of news is streaming into your iPhone now. “Call your broker!” says your money monster. “Check in with your investment advisor!”—who just happens to have an exclusive stratagem for sneaking you past the crowds of losers to the front of the line.

The money monster delights in watching our high-priced investment advisors shift money from one asset class to another in response to a war being declared somewhere or when corporation A merges with corporation B or in the face of a catastrophic event like 9/11 or Hurricane Katrina. He thrives on our gullibility when the advisor promises that if the market is about to go down, she’ll protect us by getting out in time. But all these instant responses tend to erode your investments rather than protect them. Most often, you sell to protect yourself, then re-enter the market later at a higher level—but having missed out on the gains that followed the loss you saved yourself from. You sell when the Dow is at 10,000, thus protecting yourself from its low of 8,500, but it isn’t till it’s at 11,000 that you get back in—thereby costing yourself 10 percent.

Bottom line? So many of these “protective” gyrations are really just so much sound and fury, and they signify little against the facts of the market’s reliability and the superfluity of expertise. Even if the advisor gets it right nearly every time, the advantage can be measured in pennies at best. The gyrations churn up your emotions and send your money monster into high gear, but they don’t help you make money on your investments.

### There Is No Guarantee of Future Performance

I know this because I fell for it, just as I once fell for the seductions of sun and warmth in March, just as most investors still fall for the idea that you really can stand out from the crowd and beat the market.

I was a highly trained, highly credentialed investment advisor, and like the vast majority of my fellow investment advisors, I was paying

big bucks for quarterly newsletters from stock-picking experts, was reading all the ratings, and kept shifting money from one fund to another in search of that edge that would put me—and my clients' portfolios—a step ahead of the market and a dollar ahead of the pack of other investors.

There was a fundamental fallacy inherent in this “research,” although it eluded me at the time. The stock-picking newsletters are all about what has happened in the past—how such and such a stock fund performed last year, or over the last five years. Yet the truth is that in investing, there is no actual correlation between past record and future performance. It's not like buying a television or a car, commodities whose essential features you can measure. Knowing statistics such as how many times the TV under consideration has needed repair over the last five years, or the average yearly cost of maintenance for a particular car, or what past owners have said about the item's reliability can be an illuminating guide to future performance.

Not so with stocks. Studies show there is no predictive value in a stock's performance over the course of a year or a decade. The reason? A stock that performs well is bid up in price to the point at which the future return is diminished, and the stock reverts to the mean. Think of eBay: Its stock was bid up so high that it reached a point of untenable expectations, and the performance flatlined.

And in the case of active mutual funds—funds whose manager selects the stocks to be bought and sold on a daily basis—you are in effect “buying” the person managing the fund. That means you are buying not just that individual's intelligence and experience but also her personal money madness. And unless you know the person intimately, know her childhood money messages, understand the power of her money monster, and know which emotions sway the person to which behaviors, you're buying a pig in a poke when you invest in that fund.

If I was only dimly aware of this inherent fallacy, I was nevertheless becoming acutely aware of how costly it was to invest in these active funds. By contrast, with passive investing, the fund manager is typically trying to do one of two things. He may be trying to mimic a particular market and replicate its performance by owning a representative sample of the stocks in that market—the S&P 500 index, which means mimicking the performance of the stocks of 500 well-

known large-cap U.S. companies, or the Russell 2000 index, which means mimicking the performance of 2,000 small-cap companies, to take just two common examples. These are called index funds.

Or the fund manager may be using financial ratios to slice up the market in a particular way—maybe into stocks with the lowest price-to-earnings ratio, or the smallest companies in Europe, or some such. If she's slicing, she isn't trying to replicate an index but rather to achieve high returns with a segment of the market that has a favorable track record. These are called passive funds.

Either way, in passive investing, the fund manager buys a group of stocks and holds them. An index fund manager will delete a stock from the portfolio only if and when the S&P or the Russell deletes it; a slicing fund manager drops a stock when it no longer fits the profile of the slice she has cut out of the market. Of course, expenses are incurred to buy the stocks and set up the fund, but that's about it.

In the kind of active investing I was involved in, however, fund managers constantly monitor the market, world events, and the performance of the companies represented by the stocks in their portfolios. And as they monitor, they react—to the latest hiccup in the market in Kuala Lumpur, to a change of government in Croatia, to a change of management in a company whose stock they bought a month ago. Intelligence gathering and analysis of gathered intelligence must therefore be ongoing, and that costs money; educated, trained, savvy researchers don't come cheap, and some of these fund managers employ large teams of such researchers. Most of the researchers are plugged into the world via the very latest communications technology, also not a cheap proposition; and of course, there are fees for executing the buy and sell decisions the fund managers make based on all that research. It adds up.

In time, I began to realize that if I couldn't predict how a fund manager would do in the future based on what he had done in the past, I could nevertheless be certain that the expenses the fund manager charged were eating into whatever booty his actions were realizing—namely, the return on my clients' investments. In fact, active funds typically carry expenses of 1.5 percent versus 0.5 percent for passive investing—a 1 percent difference that has a huge impact on investment returns.

For example, for a portfolio of \$100,000 that yields 10 percent per year rather than 11 percent because of expenses, the difference is an extra \$1,000 a year. (Compound that over 35 years, and you're talking about more than 1 million bucks!) Passive investing, I began to see, offered a singular advantage in terms of ultimate yield—an advantage, in sports terms, equivalent to starting on the 35-yard line in a football game versus on the 20; instead of having to get the ball 80 yards down the field for a touchdown, you have to move it only 65 yards—even less to get into field-goal range.

### I Lose to a Brainless Index

My growing awareness of these realities was part and parcel of the more general realization dawning in my brain about money madness. The sheer stress of jumping from one fund to another had begun to get to me. My health had taken a back seat to the bottom line. I was exhausting myself, the returns I was realizing on investments were hardly exceptional, and I was paying a lot in expenses—that is, my clients were.

It seemed to me that I was pursuing an elusive goal and gaining mostly a lot of stress and sleepless nights. I began to feel a bit like the guy in the vegetable juice commercial who bops himself over the head in realization of his dumbness, except that, while the commercial is flippant, I was in a state of real dejection. There had to be a simpler, better way to get all those veggie vitamins—that is, to achieve the superior returns my clients deserved without the high costs to their bottom line and my health and well-being.

Certainly, the S&P 500 offered a simpler way. It was, therefore, something of a revelation to realize that the S&P 500 and the passive index funds that matched it were achieving better returns than all the active investing I was doing at enormous expense to my clients, my health, and my happiness.

At first, I fought the realization. I did not want to believe that some boring passive fund that absolutely anybody could invest in was smarter and more successful than Savvy Spencer. And in fact, my money monster worked overtime to get me to deny the realization. The reason? If it were true that a passive index fund of 500 stocks was more

successful than I, with my Wharton MBA, my insight, and my determination, then I wasn't the powerhouse my money madness needed me to be. My shot at the cover of *Business Week* diminished with every point the S&P's performance exceeded my own. I was no longer the standout, the smartest boy in the class, the guy who had such control over money he could beat the market. Somewhere, way back in my mind, I was eight years old again, and a terrible sense of insecurity was flooding into my brain. If I couldn't do this money game as well as the S&P 500, who was I, and what was all my power and control worth?

Well, the facts were inescapable. For the years 1988 to 1992, if I had bought the index—invested in all 500 S&P stocks—I would have realized a 2.5 percent higher average return on my clients' investments than I actually achieved with all my frenzied active investing. So much for my late nights, sleeplessness, and exhaustion. So much for the adrenaline rush I had been chasing. So much for my money madness, which, in addition to making my life stressful and anxiety-ridden, wasn't even making me the big money.

It was not easy to give up on all this. In fact, it was just about the hardest thing I've ever had to do in my life—at least thus far. But the facts finally *could not* be denied: I couldn't beat the system, and believing that I could was dragging me and my life down; I simply had to let go.

I mean *really* let go: I stopped fighting my money monster. The belief that I had to outdo the market to be secure, the belief that had proven to be hollow time after time, simply evaporated.

I quit the adrenaline chase, relinquished the hell-bent pursuit of investment home runs, and gave up the active and reactive investing style I had long followed. Instead, I began to formulate the boring asset allocation strategy I would eventually call the Rainbow Portfolio. And once I did, a funny thing happened: More money came into my life. Much more money. In fact, I began to attract money like a magnet.

First, I invested solely in the S&P 500 and did better than I had done before—without a single gyration, just by staying put. Then, after a time, it occurred to me that the S&P, although offering stocks in a large number of different companies, was still, in a way, a single basket—large U.S. companies—in which to invest. So I began to *add* different kinds of investments to the S&P base, the idea being to participate in all sorts of market possibilities—still without any gyra-

tions on my part, still just staying put with this wider portfolio of investments. And that's when the difference really began to show.

My clients noticed the difference, too. Certainly, they noticed that my new approach to their wealth left little opportunity for hitting the once-in-a-lifetime grand slam. But what they could not help but see was that they were doing better than ever. In fact, while the new strategy was a yawn to talk about, the return on investment it achieved was anything but humdrum. In fact, the returns my clients were now getting were nothing short of spectacular.

**What was I doing to achieve these returns for my clients? Nothing.** Almost literally. I was not watching the Dow and reacting to its slightest ratchet up or down. I was not reading the newspapers and shifting money from one asset class to another based on world events. I was not watching the talking heads on cable TV scream back and forth about stock picks, and I was not buying and selling as the pundits advised.

Where once my clients had seen me racing all over the place, reacting swiftly to every blip on the sonar of the global economy—so that it probably *looked like* I was working hard to make money for them—I was now out of that reactive loop. When a client asked me how the market was doing, I answered honestly that I did not know. I refrained from adding that I did not care, although, to my continuing embarrassment, I don't. (The embarrassment stems from a lingering notion that a person who makes his living in the investment advising business probably ought to care.)

Instead, thanks to the structure for achieving madness-free investing and staying there—the Rainbow Portfolio—I was earning more money on investments than I had ever thought possible, and I was beginning to feel the joy and richness of being bored to death by money.

### What You'll Have to Give Up to Be Madness-Free

The cliché says that the sweetest fruit is at the top of the tree—up there where things are a little dangerous, up there where it's hard to get to. The strategy I structured as my Rainbow Portfolio is the low-hanging fruit, and we tend to look right past it. It's not as intriguing