LEAST RISK INVESTING

Avoiding Investing's
Most Common Pitfalls

MICHAEL L. GAY, MBA, CFP®

Published by:
INTELLIPRESS, LLC.
PO Box 142
Holly, MI 48442

1) Investing/Investments 2) Personal Finance 3) Financial Planning 4) General Finance 5) Self Help

Library of Congress Catalog Card Number:

Printed in the United States of America.

ACKNOWLEDGEMENTS

Dedicated to:

My parents, Howard L. and Zella M. Gay, may they rest in peace;

My brother, Richard L. Gay, Ph.D., for a lifetime of insights and tutelage;

My wife, Yvonne, for more than 30 years of loving support and encouragement;

PREFACE

"Risk is good. Not properly managing your risk is a dangerous leap."

—Evel Knievel

Least Risk Investing is my attempt to communicate, as succinctly as possible, why the most popular investment strategies fail and how those failing strategies can be avoided. It is not, for the most part, original work. There are many authors who have written extensively on the subject matter**. But, with few exceptions, their books most often resemble text books and can be difficult for the casual reader to digest. ***Least Risk Investing***, on the other hand, is my attempt to create a "Cliffs Notes" version of how the best and brightest view the process of investment management; to explain in relatively plain English and as simply as possible, what we know, what we don't know, and which approaches work. Although the story has been told many times, as long as Wall Street continues to misguide the investing public, the story cannot be (re)told enough.

The premise of ***Least Risk Investing (LRI)*** is simple: although taking risk is a necessary prerequisite to earning a return, not all risks are created equal. There are good investment risks – risks that are often worth taking because they have positive expected returns; and there are bad investment risks – risks that are completely unnecessary or whose associated returns are most likely to be negative. LRI is about avoiding (or, at least, minimizing) the bad risks and, just as important, appropriately managing the good risks.

So, whether your portfolio is worth $10,000 or $10,000,000; whether you're retiring in 1 year or 30 years; whether you're new to the game of investing or a seasoned do-it-yourselfer, the tenets outlined herein will serve you very well for decades to come. If you use them well, you should do far, far better than the majority of investors and you should vastly improve your odds of meeting your most important financial goals – whatever they may be.

** In writing ***Least Risk Investing***, I have borrowed frequently and shamelessly from the best and brightest investment minds on the planet. So let me take a few minutes of your time to introduce you to some of these people. Since I quote them frequently, it is important for you to understand that these are the movers and shakers in the investment management industry. They – not the self-promoting rock star money managers that are so often cited in the popular press – are the crème de la crème.

William J. Bernstein is a practicing neurologist, self-taught investor extraordinaire and – remarkably – one of the most proficient writers on the topic of investment management. He has one of the best investment-related "newsletters" on the Internet (www.efficientfrontiers.com) and has written several outstanding books, including *The Intelligent Asset Allocator* (McGraw-Hill, 2001), *The Four Pillars of Investing* (McGraw-Hill, 2002), and *The Birth of Plenty* (McGraw-Hill, 2004).

John C. Bogle is the Founder and retired CEO of the Vanguard Group, one of the largest mutual fund companies in the world. In addition to numerous articles, he has written several books on investment management, including *Bogle on Mutual Funds: New Perspectives for the Intelligent Investor* (1993, McGraw-Hill), *Common Sense on Mutual Funds: New Imperatives for the Intelligent Investor* (John Wiley & Sons, 2000), and *John Bogle on Investing: The First 50 Years* (McGraw-Hill, 2000).

Charles D. Ellis is one of the leading thinkers in investment management. He is recognized as one of the foremost experts on investment policy and investment management, and he was the first to acknowledge – back in the early 1970s – that investing had become a loser's game. He was Managing Partner of Greenwich Associates, the global leader in consulting to the investment industry, and has taught graduate-level investment courses at both Harvard and Yale. He has served as chairman of the Association for Investment Management and Research (AIMR) and as Director of the Vanguard Group. Ellis has authored dozens of articles on investment management and finance, as well as several must-read books, including *The Investor's Anthology* (John Wiley & Sons, 1997), *Winning the Loser's Game* (McGraw-Hill, 2000), and *Capital: The Story of Long Term Investment Excellence* (John Wiley & Sons, 2004).

Eugene Fama is the Robert R. McCormick Distinguished Service Professor of Finance at the University of Chicago. He is best known for his work on portfolio theory and asset pricing. His Ph.D. thesis, which concluded that stock price movements are unpredictable and follow a random path, was published in the January 1965 issue of the *Journal of Business*. Entitled "The Behavior of Stock Market Prices," his work was subsequently rewritten into a less technical article – "Random Walks in Stock Market Prices" – which was published in the *Financial Analysts Journal* in 1966 and *Institutional Investor* in 1968.

His best-known work, however, is a series of papers co-written with ***Kenneth French*** describing the factors that characterize stock returns in terms of market capitalization and book-to-market ratio. Known as "The 3-Factor Model," this groundbreaking work inspired the founding of Dimensional Fund Advisors, one of the first companies to offer index funds. Dr. Fama is the author of the efficient markets hypothesis and is widely perceived as the "father of modern finance."

Richard (Rick) Ferri was one of the original champions for low-cost, passive investment management. Rick authored ½ dozen books on investing and investment management, was a Forbes.com and Wall Street Journal columnist, and coauthored a white paper that won the S&P Dow Jones Indices' 3rd Annual SPIVA Award for a research report. Rick is also a Marine Corps veteren and flew fighter aircraft. Rick is now retired, traveling the country and blogging about his adventures. I was fortunate to have worked for Rick's firm before he retired.

Roger C. Gibson, CFA, CFP®, is a nationally recognized expert on asset allocation and portfolio design and is the author of *Asset Allocation* (McGraw-Hill, 2000), one of the best technical books written on the topic.

David B. Loeper, CIMA®, CIMC® is the Founder, Chairman and CEO of Financeware, Inc. Mr. Loeper is a prolific writer and, through his company's white papers, has successfully changed the way many in the industry view financial planning and investment management. Before founding Financeware, Mr. Loeper was Managing Director of Strategic Planning for the retail brokerage division of Wheat First Union and served on the Investment Advisory Committee of the nearly $30 billion Virginia Retirement System. Mr. Loeper is frequently featured at industry events, contributes to various industry publications, and has appeared on CNBC, Bloomberg TV and Yahoo! FinanceVision. He is a member of IMCA (the Investment Management Consultants Association) and earned the CIMA® designation (Certified Investment Management Analyst) through Wharton Business School, in conjunction with IMCA.

Burton G. Malkiel is the Chemical Bank Chairman's Professor of Economics at Princeton University. He holds BA and MBA degrees from Harvard University and a Ph.D. from Princeton. Dr. Malkiel is the author of the best-selling *A Random Walk Down Wall Street* (W. W. Norton & Co., 2003, now in its 8th edition). In addition, he has authored or co-edited numerous other books including *The Index Fund Solution* (Fireside, 1999, with Richard Evans). Dr. Malkiel is a past appointee to the Council of Economic Advisors and is a Director of the Vanguard Group.

Harry Markowitz is best known for his pioneering work in Modern Portfolio Theory, which describes the effects of risk, correlation, and diversification on expected portfolio returns. His research was essential to the development of the Capital Asset Pricing Model, a mathematical model developed by William Sharpe (see below), John Lintner, and Jan Mossinto to determine an "appropriate" price of a security.

In 1990, Markowitz, Sharpe, and Merton H. Miller were awarded the Nobel Prize in Economics for their contributions to finance. Markowitz earned his Ph.D. at the University of Chicago. He has taught at Baruch College of the City University of New York since 1982 and has published several studies and monographs including *Portfolio Selection: Efficient Diversification of Investments* (Blackwell, 1991).

Leonard Mlodinow is a theoretical physicist and best-selling author five books, inlucding *The Drunkard's Walk: How Randomness Rules Our Lives* and *Subliminal: How Your Unconscious Mind Rules Your Behavior*.

William F. Sharpe is the STANCO 25 Professor of Finance, Emeritus, at Stanford University's Graduate School of Business. Dr. Sharpe was one of the originators of the Capital Asset Pricing Model (CAPM) and developed the Sharpe Ratio for investment performance analysis, as well as returns-based style analysis for evaluating the style and performance of investment funds. In 1990, he received the Nobel Prize in Economic Sciences for his work on the CAPM.

Jeremy J. Siegel is the Russell E. Palmer Professor of Finance at the Wharton School of the University of Pennsylvania. He has written and lectured extensively about the economy and financial markets and served for 15 years as head of economics training at JP Morgan. Professor Siegel is the author of *Stocks for the Long Run* (McGraw-Hill, 2000) and *The Future for Investors* (Crown, 2005). *Stocks for the Long Run* was named by *Business Week* magazine as one of the top ten business books published in 1994 and by James Glassman of the *Washington Post* as one of the ten best investment books of all time.

Larry Swedroe is principal of BAM Advisor Services, LLC, a service provider to investment advisors across the country, most of whom are affiliated with CPA firms. He is author of eleven books on investment management, including best-sellers such as *The Quest for Alpha* (John Wiley & Sons, 2011), *Investment Mistakes Even Smart Investors Make* (McGraw-Hill, 2012, with RC Balaban), and "The Only Guide" series (various).

Nassim Nicholas Taleb is a self-described "epistemologist of randomness". He is the author of *The Black Swan* (Random House, 2007), a book described by the Sunday Times as "one of the twelve most influential books since World War II", and *Fooled By Randomness* (W. W. Norton & Co., 2001), which has been dubbed "the book that rolled down Wall Street like a hand grenade." He has been a professor at several universities, a hedge-fund manager, and is currently an advisor for the International Monetary Fund.