Chapter 7

Mass Market Investment Advice - A Recipe for Mediocrity

People are motivated by two things: fear and greed. They are afraid to lose what they have and they are greedy to get more.

Bert Cornfield- legendary mutual fund salesman

Ask any investment advisor why you should be in the stock market and they will answer, "Over the long-term, stocks produce higher returns than bonds or money market funds." Then they will likely point to historic charts and graphs to prove their point. Advisors are correct about the return of stocks. Over time stocks have produced higher returns than bonds or money funds. But the question arises, when they say the word "stocks", what stocks are they referring to? Most advisors are referring to the entire stock market.

It is obvious that a great number of people invest in stocks because the stock market as a whole has performed well in relation to other investments. Since it is the market that attracts people, an investment in the entire stock market would make sense for most individuals. That way they get the return of the investment that interested them in the first place. Since this is the case, it would be logical for the public to buy index mutual funds. There are lots of index funds, but an index fund benchmarked to the US stock market is designed to invest in a portfolio of stocks that matches the performance of the entire stock market, less a very small management fee.

A major breakdown occurs in the investing process when a person asks an investment advisor, "How should I invest in the stock market?" Unfortunately, most advisors do not recommend people buy index mutual funds. They recommend some other stock investment that has a poor chance of achieving the performance of the stock market. Why do most advisors recommend inferior investment products given the clear advantage of index funds? The reason is the advisor is paid a fee to do so. There is no other reason.

A Conflict of Interest

Part I of this book explained three reasons why individual investors earned significantly lower returns than the markets they invest in. High expenses, poor market timing decisions, and chasing hot investment styles have resulted in a wide performance gap. Part II of this report looks at how the investment industry and mass media encourage investors to behave in a manner that causes a wide performance gap. We will look at the sellers of investment advice, and how their personal goals conflict with the goals of investors.

Wall Street is an exciting place. It represents free markets, capitalism, and opportunity for everyone. But it is also wrought with false promises and questionable sales practices. Whether you are working with a stockbroker or reading an investment magazine, you are faced with the daunting task of separating fact from fiction in an industry whose primary goal is to make money *from* you, not *for* you.

Where the Public Gets Investment Advice

Individual investors generally get their advice from three places; the popular press (including the Internet), friends and relatives, and paid advisors. In 1998, Kansas City based American Century conducted telephone surveys of several hundred individual investors and asked them to list their sources of investment advice[1]. The category mentioned most often was the financial press, i.e. magazines, newspapers, TV, and the Internet. Other top sources of advice were friends and family, and paid advisors.

Sources of Advice for Investors

Source of Advice	% Mentioned
Financial media	44%
Friends and family	39%
Accountants and tax advisor	32%
Independent financial planners	29%
Stockbrokers	28%
Bankers	25%

In 1997, the NASDAQ Stock Exchange conducted a similar survey of individual investors who considered themselves "well informed". NASDAQ asked the group where they got their investment information. About 38% read the *Wall Street Journal* daily and 23% read *Money* magazine each month. Close to 38% watched TV shows like *Wall Street Week* or listened to radio talk shows. Only 20% look to their local newspaper for advice, down from 58% in 1985. As far as the human touch goes, informed investors rely heavily on professional advice, with brokers and other financial consultants leading the pack.

Professional Advisors of "Well Informed" Investors

Personal Advisor	% Mentioned
Stockbrokers (including financial planners)	52%
Friends and relatives	51%
Accountants	43%
Bankers	38%

[1] As reported by Dow Jones news service April 7, 1998

As you can garner from the answers above, most people use two or three sources of investment information when managing their portfolios. Some of the advice comes from print, some from radio, TV and the Internet, some from friends and relatives, and some from advisors. Are these sources of information unbiased? Do they give you all the facts? Not by a long shot. Conflicts of interest run rampant in the investment industry. It takes a clear mind to sort out one or two relevant facts from the investment noise.

It is interesting to note what's missing from the surveys. No one mentioned investment courses offered though local colleges and universities. Many places of higher education run informative, non-sales oriented classes on financial planning and investment management. It's a great place to obtain unbiased (or less biased) investment information.

Perhaps the public believes the advice they are getting outside of academia comes from knowledgeable and properly educated people. That would be a dangerous assumption, and potentially a costly one. We will learn in later chapters that many people in the investment advice game are not well trained, and are certainly not experts.

A Recipe for Mediocrity

For a long time I have not said what I believe, nor do I believe what I say, and if indeed I do happen to tell the truth, I hide it among so many lies that it is hard to find.

Machiavelli in a letter to Fancesco Guicciardini, May 17,1521

Most investment advice sold en masse to the public is a *recipe for mediocrity*. The advice tends to revolve around the concept of "beating the market". While it is possible that mass-market advice may lead to superior returns in the short run, it is destined to fail in the long-term. It is not conceivable that majority of investors beat the market, especially after fees and expense. Yet beat the market advice is in demand, and the burgeoning investment industry finds that demand to be very profitable.

By the time an investment idea makes it's way to the general public, the idea is old. There may be some momentum in the markets that carry the idea forward for a while, but in the long run the public is always late to the game. The markets adjust so fast, the individual investors have little chance to capitalize on new information. Stockbrokers and investment advisors may be one small step ahead of the public, but that makes little difference. Most advisors are not skilled enough to make superior investment decisions.

Since almost everyone has access to the same market information at about the same time, only *opinions* and *interpretations* can differ. These opinions appear all around you in the form of newspaper articles, analyst comments, advice from CNN, and your broker. Some opinions sound more credible than others, and some people may be able to accurately interpret the news and profit from it, but overall the markets adjust too quickly for any individual investor to consistently capitalize on new ideas.

Does anyone get better information? Although it is not supposed to happen, institutional investors with large holdings in a stock may have access to information before it becomes public knowledge. Al Dunlap, former CEO of Scott Paper and Sunbeam, clearly explains this in his book *Mean Business.* Dunlap wrote, "A small investor doesn't have access to the information and resources Soros does[2]." He was referring to private meetings between Scott Paper and an investment group representing hedge fund manager George Soros. The hedge fund made a large profit when Dunlap sold Scott Paper to Kimberly Clark. However, institutional investors do not always profit from extra information. Many institutions lost a bundle when Dunlap could not find a buyer for Sunbeam and the company collapsed.

A Preview of the Chapters in Part II

Part II refutes the marketing claims of the sellers of investment products and advice. There are no superior methods of investing that "beats the street" consistently. Advisors and other investment "experts" that sell beat the market strategies have an ulterior motive, making money for themselves. I have found no evidence that beat the market advice works, only that following it leads to mediocre results.

Preview of Chapter 8 – The Myth of Investment Experts

The public has a little knowledge of the way Wall Street works. Large brokerage firms have hundreds of analysts covering thousands of investments, plus dozens of economists following the economic beat. This impressive network of brainpower may give investors the impression that their stockbroker or advisor is very knowledgeable and offers superior advice. This impression is typically far from reality.

Most advisors who consult directly with individual investors are not highly trained, nor are they knowledgeable in an academic sense. A large majority of stockbrokers, financial planners, insurance people, and independent advisors are strictly salespeople, whose training is limited to firms they sell for. Chapter 8 looks at the people we turn to for investment advice, and it exposes a major shortfall that exists in the education and training of most "investment professionals".

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[2] Albert J. Dunlap, *Mean Business*, Fireside, NY, 1997, pg. 264

Preview of Chapter 9 – The Persuasive Power of the Printing Press

Selling investment advice via the printing press is a multi-million dollar business. There are now dozens of newsstand publications that offer investment advice for $2.50 or less. Unfortunately, most of the information in these publications is based on market hype and strategies encouraging readers to *chasing the hot dot*, described in Chapter 6.

Some journalist at established publishers are well educated in financial subjects, while many others lack elementary knowledge about the economics and the markets. Reporters frequently quote investment "experts" in their stories. Ironically, many publications only interview "experts" who advertise in their publication, regardless of their skill or knowledge.

Investment books come in all sizes and colors. The best books are based on years of academic research and practical experience. Legendary investor Peter Lynch wrote two books about beating Wall Street at its own game. While these books were entertaining, I doubt any reader "Beat the Street" as a result. Even Peter Lynch himself admits that it is a very difficult undertaking, and that the idea of owning the entire market through a low cost *index fund* has a lot of appeal. Unfortunately, many books are of the get-rich-quick variety. Authors who write these books only intend to make money for themselves, not their readers.

Preview of Chapter 10 – Mutual Fund Follies

In 1946, Ed Johnson, president of Fidelity Investments, explained to the SEC that beating the market is not the goal of his company, "The management has no illusions it can beat the market and does not try...rotation of investments often occurs"[3].

Fidelity's business plan was to create dozens of funds, pushing the good ones and closing the bad ones. Ned Johnson, Ted's son and subsequent president of Fidelity, would begin a new fund even if he would not put *one nickel* of his own money into it[4]. This strategy has worked for *Fidelity Investments*, the nations largest fund company. As of 1998, *Fidelity* offered over 100 funds and 57 different stock funds.

Mutual fund companies have become the leading investment choice for individual investors. Since beating the market is difficult, successful fund companies have learned the key to the business is

[3] Daina B. Henriques, *Fidelities World*, Scribner, NY, 1995, pg. 105
[4] Ibit, pg. 234, interview with Mark Shenkman, a former money manager at Fidelity.

based on opening new funds in hot sectors, and having a strong marketing plan. By offering dozens of funds, a firm hopes one or two will be a winner, so they can exploit those funds and gather assets.

Summary

Do not confuse the goals of the investment industry with your own goals. While there are many fine people working in the field, the real goal of the industry is to make money from you, not for you. As a result, most mass-market investment advice *encourages* behavior that widens the performance gap. As long as investors continue to seek superior returns, they will continue to pay commissions, buy subscriptions to investment magazines and newspapers, seek the advice of a paid advisor, and purchase an assortment of other products and services provided by the investment industry. This is a recipe for mediocrity.