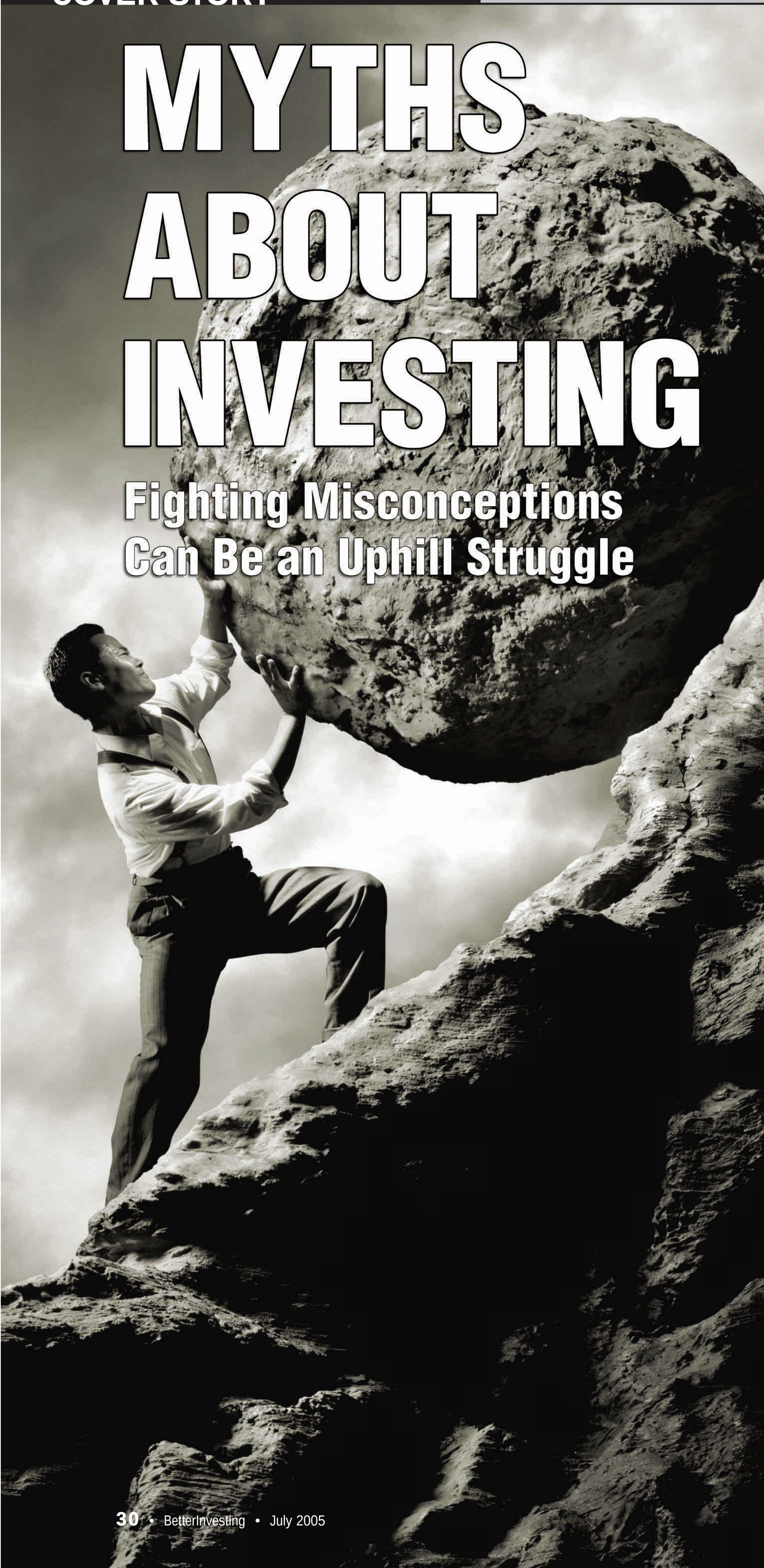
MYTHS ABOUT INVESTING

Fighting Misconceptions Can Be an Uphill Struggle



by Kevin Lamiman, Associate Editor

In one well-known Greek myth, Sisyphus offended the gods and was sentenced to an eternity of futile effort and frustration. This tragic figure was condemned forever to roll a large boulder up a slope only to see the stone roll back down to the bottom of the hill each time just as he reached the top.

Like Sisyphus, beginning investors may struggle against a great weight — the weight of various investing myths, beliefs repeated so often that many people assume they represent the truth. Experienced investors may hear those myths repeated when they talk to others about the merits of stock ownership.

BetterInvesting Magazine asked three longtime members of its Editorial Advisory and Securities Review Committee to address some of the most common misconceptions about investing and to suggest ways to counter the arguments of skeptics. Drawing on their several decades of collective experience, the Detroit-area trio provided insights into the myths that can keep investors from reaching the top.

The Gambling Question

"*Stock investing is just the same as gambling.*" This may well be the most widely held misconception about stocks. You may have heard it repeated by your know-it-all brother-in-law or by the cynical owner of a local business you patronize.

Although risk exists in both investing and gambling, the two activities are fundamentally different, says Maury Elvekrog, chairman of investment management service Seger-Elvekrog Inc. in Bloomfield Hills, Mich. It's important first to define a stock certificate correctly as a proportional share in a business, he says. If the business is well-managed and profitable, the shareowner doesn't need to worry about variations in the value of its stock or in the gyrations of stock market indexes. And with adequate diversification, a problem in one company — and a big drop in the value of its stock — will have minimal effect on the portfolio's overall returns.

The long-term upward progression of their values sets stocks apart from gambling, which produces nothing overall except a profit for the casino owner. Gambling transfers wealth from losers to winners. In contrast, stock investing funds businesses that can grow.

"Long-term investing isn't a zero-sum game," Maury says. "Everybody theoretically could be a winner. Whoever bought a particular stock 50 years ago could have sold it to someone else, who sold it to someone else, who sold it to someone else. If the business grows over all those years, everybody could do well.

"If you invest, you're not taking something from somebody else. You're doing something effective for the economy, and you and other investors participate in the reward."

Anyone with average intelligence and skills can succeed investing in individual stocks — if they choose to put in the work.

— Bob Bilkie

Another difference between gambling and investing is that the more times you return to the gaming tables, the lower the chances you'll finish ahead; that's what the laws of probability dictate. With stocks, however, the opposite is true: The longer you invest, the stronger the likelihood you'll have gains.

"If you go to Las Vegas and stay long enough, you'll be broke," says Walter Kirchberger, a senior adviser to the chief investment officer at Sigma Investment Counselors in Southfield, Mich. "But if you invest consistently in the U.S. stock market and if you do it long enough, you'll be rich.

"You can argue whether the long-term rate of return for common stocks is 7 percent or 9 percent or 11 percent," he says, "but regardless, it's a plus number."

Not only have stocks grown in value over time, but they've grown faster than other asset classes, Walter says. That's illustrated in a classic treatment published regularly by Ibbotson Associates Inc. *(see page 32)*. The chart also illustrates how the passage of time dampens the impact of stock market volatility, Walter says. "Remember the last time the markets fell 20 percent? Try to find it on the chart."

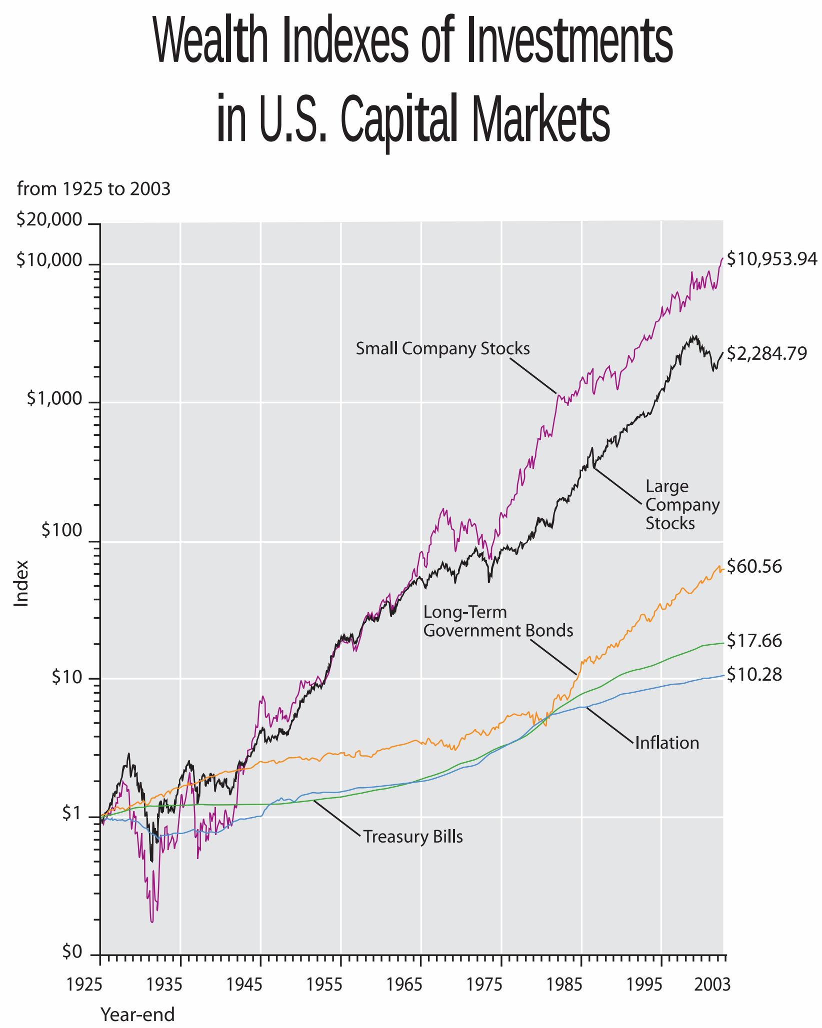
Indexing Is Best?

Over the past 40 years economist Eugene Fama of the University of Chicago has argued that stock markets are "efficient" — that is, stock prices accurately reflect the rational, collective decisions of investors with access to lots of information about companies. As a result, the concept suggests, investors can't "beat the market" by picking individual stocks. Their best choice is to invest in stock index mutual funds and to accept market-average returns. The efficient-market theory and the benefits of index investing were popularized by Princeton University economist Burton G. Malkiel in his book *A Random Walk Down Wall Street.*

The committee members disagree with the idea that individual investors can only come out ahead with what amounts to total diversification — owning all the stocks in a given index, both the good and the bad.

That's not to say diversification is unimportant. "If you buy just one stock, it's hard to know whether your decision will turn out well," Maury says. "But if you buy about 15 different stocks, you can have greater confidence."

Nobel Prize winner William F. Sharpe supported the adequacy of limited diversification in a paper published in 1972 in the *Financial Analysts Journal.* He argued that as the first few stocks are added to a portfolio, nonmarket risk — that is, risk specific to individual stocks and independent of developments in the markets or the overall economy — declines rapidly at first. The



Clear Advantage. This classic chart from Ibbotson Associates demonstrates how well U.S. stocks have beaten the returns on government debt instruments and the rate of inflation over the past eight decades.

decline in risk slows as the number of stocks enters the teens and plateaus at a relatively low level when the portfolio size climbs to about three dozen.

There can be good reasons other than diversification for investing in index funds or other mutual funds, committee members say. For one thing, mutual funds often are the only choice made available in employer-sponsored retirement plans.

Bob Bilkie, CEO of Sigma Investment Counselors, says that anyone with average intelligence and skills can succeed investing in individual stocks — if they choose to put in the work. "I've seen enough people in my business who are well-suited to do their own investing, but they don't have the time or inclination to do the research," he says.

People who are prone to base investment decisions on emotions might be better off with index investing, even though it means settling for market-average returns. "They can at least get results sufficient to achieve their financial goals," Bob says.

Age, Assets and Allocation

Workers planning for retirement are often advised to diversify across several asset classes, investing in stocks, bonds and short-term savings to keep risk manageable. Since stocks are perceived as riskier, other assets should make up a growing proportion of their wealth as they age, the thinking goes. The most common rule of thumb is to subtract age from 100 to determine what percentage of wealth should be in stocks.

The formula makes no sense to Bob. "Why not take the age of your children, add 15 and divide by 2?" he asks. "The result is the same logic. A better alternative is to determine what you're trying to achieve and how much risk you can accept, defining risk as volatility, or the risk of a complete loss."

Investors should determine the minimum portfolio size they can live with, should share prices fall significantly. "If it's $1 million, they probably shouldn't be investing in stocks," Bob says.

"Every four or five years, on average, the markets experience a 20-percent drop," he says. "Could you take a 20-percent drop? Every 40 or 50 years the markets see a 40-percent drop. If you think it's plausible that could happen within your time frame, maybe you shouldn't have more than about 50 percent of your assets in stocks."

Maury calls the age formula an absolutely terrible approach to investment planning. Instead, investors should maintain two portfolios. One should consist entirely of growth stocks. The other should be a "security" fund made up of short-term bonds or money market mutual funds to cover emergency expenses and to take advantage of investment opportunities. The size of each portfolio depends on the investor's cash-flow needs.

Retirees would determine how much of their wealth they need to supplement income sources such as pensions and Social Security. All other assets should be in growth stocks, he believes.

Walter says the age formula makes sense only if investors plan to spend all their wealth before they die. Otherwise, the purpose of their investment wealth should be the determining factor in asset allocation.

"There's no one-size-fits-all strategy," he says. "I'm heavily invested in stocks to benefit my grandchildren. My age is immaterial to that."

Losses on Paper

When share prices decline, investors may gain comfort from thinking that if they don't sell, they haven't lost anything. That line of thinking can prove costly, Bob warns. Because most of us have a strong aversion to financial loss, we may go through mental gyrations to justify keeping a stock that no longer belongs in the portfolio.

"What you may have lost is the potential opportunity from redeploying the proceeds from selling your crappy stock," he says. "Investors sometimes trick themselves into believing that a stock owes it to them to at least make back what they paid."

Maury says share price should have little to do with whether the stock stays in the portfolio or goes. Investors should base their portfolio decisions on more substantive and objective reasons.

"It oversimplifies things a bit, but there are essentially just two reasons for selling: The business shows problems, or there's a better alternative," he says.

Find the Right Guru

It's tempting to believe that with just the right system, we can beat the market and rake in substantial profits from "investing." That's the sort of thing promised by innumerable television infomercials, newsletters and websites.

The challenge, of course, is finding the right expert or picking the best newsletter, training video or software package. For example, plug the words "investment newsletter" into the Google search engine and you'll locate about 450,000 websites containing the phrase.

No one seems to have ever counted up all these specialized stock market publications and websites. Representatives for the U.S. Securities and Exchange Commission and the New York Stock Exchange say their organizations have no idea how many are in the marketplace.

The apparent appeal of these supposed stock experts reflects human nature, Maury says. "I think it's because people are looking for some sort of magic. They're looking for an easy, canned, whiz-bang approach. Unfortunately, there is no simple, mechanical process we can use to achieve investing success." BI