Chapter One
Hope Is Not A Strategy
Before we plan for the future, let us learn the lessons of the past.

The four most dangerous words in the investment vocabulary are, "It's different this time." Let me explain.

Someone once said that the only thing we ever learn from history is that we never learn from history. When it comes to investing, that absolutely seems to be the case. The bursting tech stock bubble of the 1990s and the exploding real estate bubble of the last year are just the latest incarnations of an age-old problem: when investment hysteria sets in, normally rational people make very irrational decisions.

Contributing to that irrationality are the "financial experts," those purveyors of financial wisdom who are seldom right but never in doubt. In centuries past, they spoke in the public square, while today it is on television or in financial magazines but the message remains the same: the old rules no longer apply, what goes up need not come down, the bubble will continue to grow and it will not burst. Many investors have gone broke listening to the experts, many of whom are little more than financial pornographers.

I am reminded of a story I heard about the country singer Willie Nelson, who upon being caught by his wife in the act with another woman did not miss a beat, looking at her and asking, "Are you going to believe what I tell you or are you going to believe your lying eyes."

History is filled with examples of this kind of hysteria, where we are asked to believe our "lying eyes."

The Tulip Bulb Bubble

In the instance of 1593 Holland, we can see how the lure of easy riches can create both great financial excitement and financial ruin. A sailor returned from a trip with a new variation of tulip. They sold at somewhat inflated prices right away, but when a non-fatal virus called Mosaic developed vibrant stripes on the tulips, it was perceived that they were of great value and a huge market developed for them that created complete market hysteria. Charles Mackay, in his book "Extraordinary Popular Delusions and the Madness of Crowds," noted that commerce in Holland ground to a halt as "nobles, citizens, farmers, mechanics, seamen, footmen, maid-servants, even chimney sweeps dabbled in tulips."[1]

One story that came out of the period was of a man invited to a meal at a wealthy merchant's home. The poor man ate what he thought was an onion but was actually a rare tulip and was promptly imprisoned for his mistake on a felony theft charge. Eventually, the craze ended, and the tulip market collapsed—and with it the financial fortunes of countless investors in 1590s Holland.

As the Tulip Bulb craze was going on, many investors chose to believe that the old rules did not apply, that the law of investment gravity would not bring the tulip bulb prices back to earth, that, “”It’s different this time.” It was not.

The South Seas Craze

Flash forward 150 years to the South Sea craze. Of this investment hysteria, it was none other than Sir Isaac Newton who said, “I can calculate the movement of the stars but not the madness of men.”[2] Sir Isaac knew that of which he spoke, as he himself lost about 20,000 British pounds (the equivalent of several million dollars today) when the South Sea investment bubble burst. One of the legends of Sir Isaac Newton is that he began to make his pioneering observations about gravity when he saw an apple fall from a tree. As we will see, if Newton would have applied a simple principle of “financial gravity” he might have saved himself a fortune: that which rises high and fast into the sky, will come down hard and fast when it plummets back to the ground. It is true of apples, and it is true of money. What happened?

In 1711, when the South Seas Company was formed, the new world still had about it an air of being exotic. The South Seas (which meant what is today South America) was a place where the popular imagination believed there were untold riches to be had. The government owning sectors of the private economy the was the United States now owns stakes in General Motors and AIG is not a brand new phenomenon, as the British government was a partner in the venture with the South Seas company. Money began to flow into the company, with investors lining up to place their money on what they thought was a sure thing. Much like some of the internet stocks of the 1990s that grew (for a little while) to astronomically high stock prices, investors didn’t really know what they were investing in. One advertisement looking for new investors said, “a company for carrying out an undertaking of great advantage, but nobody to know what it is."[3] That’s not a misprint you are reading … investors were told to bring their money but not their questions, because no one was going to tell them what they were investing in!

The bubble continued to grow, aided in part by the publication of the names of many of the members of the aristocracy and the political leadership of England. Potential investors thought to themselves, “If all of these brilliant and wealthy people are investing in the South Seas company, then I had better get in before it was too late.” The stock price increased in a very short period of time by 1000%, with many investors borrowing money to buy shares. It seemed like the stock price was defying all laws of logic and reason, but investors comforted themselves by saying, “”it’s different this time.” Eventually, the bubble burst and with it the fortunes of the famous (the composer Handel was ruined) and the not so famous.

In hindsight the crash seemed to have been inevitable in light of the mass hysteria, but before we pick up the gavel to judge the foolishness of those South Seas investors, let’s continue our march through the history of bursting bubbles … jumping ahead 200 years to the 1920s in the United States.

The Roaring 20s and the Great Depression

Fueled by the relief and optimism that followed the end of the First World War, the 1920s was a heady decade. It was the decade of jazz, of F. Scott and Zelda Fitzgerald, of Babe Ruth. The automobile was becoming commonly owned by common people, radio was all the craze and the future seemed limitless. The stock market reflected this, as stocks roared to higher and higher values. From 1921 to 1929, the Dow Jones average increased from 60 points to 400 … to put that in perspective, as I write this the Dow Jones average is around 10,000 points. A growth similar to that period in the 1920's would mean that in 8 years the Dow would be at 65,000 points!

The market was incredibly over heated, with many people who had never invested in the market before jumping on the stock band wagon. One story from that era is of Joseph Kennedy, the patriarch of the Kennedy political dynasty. About a month before the market crashed, he was having his shoes shined one afternoon in New York and was startled by the man shining his shoes bragging about his stock portfolio. Kennedy quickly surmised that if the shoe shine man was jumping in the market, than stocks had to be overvalued and he pulled his money out of the market in time to avoid the crash. The political history of the 20th century in the United States might have been very different if he had not.

The experts of the day were very dismissive when doubts were raised about whether this was a bubble that was soon to burst. Irving Fisher, one of the leading economists of the day, said, "Stock prices have reached what looks like a permanently high plateau."[4] The newspapers of the day echoed that theme. Here are some of the headlines from three New York newspapers in 1929:

"Banker Says Boom Will Run Into 1930"
The World, March 30, 1929

"Brokerage Houses Are Optimistic"
New York Times, October 25, 1929

"Brokers Believe Worst Is Over and Recommend Buying of Real Bargains"
New York Herald Tribune, October 27, 1929

That last headline appeared in the newspaper 2 days before Black Tuesday, the day the market came crashing down … the experts still saying, "come on in, the water is warm, " just as the storm was about to hit the shore.

The headline in the New York Times the day after Black Tuesday describes what happened, as well as the initial response of the experts:

"Stocks Collapse … But Rally At Close Cheers Brokers, Bankers Optimistic"

New York Times, October 30, 1929

That's right … the market had just collapsed, but the brokers were cheered and the bankers were optimistic. If you would you have been a stock investor at that time, your broker may very well have been telling you, "Just stay the course. The market is about to come back." Well, the market did come back to its 1929 levels … 25 years later. Economist Richard Salsman states it this way: "Anyone who bought stocks in mid-1929 and held onto them saw most of his or her adult life pass by before getting back to even."[5]

The Dot.Com Frenzy

Well surely we would have learned our lesson after that, wouldn't we? Maybe not.
Flash ahead 70 years. In the 1990's a dotcom bubble began that kept growing and growing and growing. Companies with very little track record, no profitability and (in some cases) no product of value to offer, saw their share prices grow dramatically. This meteoric rise defied the laws of economic gravity … for awhile. The Price to Earnings Ratio (the value of the stock in comparison to the amount of money – if any—that the company was actually earning) of many of these companies was breathtakingly out of balance. People said as the bubble grew that the old rules of investing did not apply, that "it's different this time." Well, it wasn't different that time, and when the dotcom bubble burst, the values of the companies that had fueled the frenzy plummeted. One company, Infospace, saw its stock reach a height in March of 2000 of $1,305 per share. One year later, in April 2001, its price had fallen to $22 a share. Many other companies simply ceased to exist, with the market overall losing $3 trillion in value between 2000 and 2002. In January of 2000, shortly before the market burst, 17 dot.com companies spent $2 million each for a 30 second ad during Super Bowl XXXIV. One year later, just 3 dotcoms advertised during Super Bowl XXXV.

The Bursting Real Estate Bubble

Surely investors caught up in the dot.com frenzy learned their lesson to not listen again to the "financial pornographers" (who call themselves "experts") telling them that the old rules do not apply, the bubble will not burst and that "it's different this time." Sadly, the lesson did not stick. Just a few short years later, we were caught up in a real estate frenzy. Yale economist Robert Shiller said in 2005, "Once stocks fell, real estate became the primary outlet for the speculative frenzy that the stock market had unleashed. Where else could plungers apply their newly acquired trading talents? The materialistic display of the big house also has become a salve to bruised egos of disappointed stock investors. These days, the only thing that comes close to real estate as a national obsession is poker."[6]

There were regions of the country where home values that had historically risen in value 3 or 4% per year were growing in value at a rate of 20 and 30% per year. Credit was being extended through sub-prime loans to people who in the past could not have qualified for a mortgage because it was believed that the old rules no longer applied, that "it was different this time." The logic was that bad debt obligations were not as troubling as they once might have been because of the incredible rise in home values. If someone defaulted on a mortgage it was not thought to be a problem because the lender could always sell the home for more than the value of the remaining mortgage. Caught up in the speculation, many Americans for the first time began to use real estate as an investment. Homes purchased primarily for investment purposes increased by 50 percent.[7] When this bubble burst, the repercussions were enormous, almost throwing the United States into another depression, and sending not only General Motors and AIG into bankruptcy court, but also countless Americans who had once again become victims of speculation and hype.

The bottom line is that all of the hype and speculation in the world is no substitute for a well thought out, diversified and disciplined plan. In other words, hope is not a strategy.

Beware the Stock Pickers

Turn on the financial news programs at night and you will see them. Listen to the financial experts on the radio and you will hear them. Open the financial magazines and you will read them. The experts. Men and women who are bold in their financial predictions and stock picks, and conspicuously quiet when those picks are proven wrong. Seldom right, but never in doubt. These sources of information that appeal to our desire to get rich quickly can be very harmful to our long term financial goals. This “financial pornography” is often focused not on a long term, highly diversified portfolio, but rather on the “expert’s” ability as a stock picker. As we will see later in Chapter 5, what dictates success or failure in investing has far more to do with asset class diversification than with the ability to be a stock picking genius. In fact, a study published in 1991 in the Financial Analyst Journal, indicated that market timing and good stock selection only account for about 9% of investment results, but that asset allocation accounts for 91% of the outcome.[8]

One quick example. Fortune magazine, for their 1999 Retirement Guide issue, assembled a team of experts to recommend stock in a select few companies "with the size, stability, and earnings power to carry investors through whatever the market throws their way in the decades to come."[9] Let’s look at those 10 companies nearly a decade into the future (July 13, 1999 through June 13 2008) and see how they have fared:

Company	Ticker	Gain/Loss
American International Group	AIG	-46.1%
Bristol-Myers Squibb	BMY	-64%
Cisco Systems	CSCO	-19.2%
Ford Motors	F	-87.4%
Home Depot	HD	-36.6%
International Business Machines	IBM	-8.5%
Johnson and Johnson	JNJ	37%
MCI WorldCom	WCOM	-100%
Tyco International	TYC	-34%
UAL Corp	UAL	-100%

Nine of the ten stocks went down in value, two of the companies are no longer in business, and during a time period when the Standard and Poor 500 Index was down 2.4%, these 10 stocks (picked by the experts) *were down 46.1% on average.* All of the "expert" advice in the world cannot take the place of a well-disciplined, long-term, diversified plan. Avoid financial pornography.

There is nothing wrong with desiring to build wealth and then taking steps to accomplish that over time. To get rich slowly, seeking to be a wise steward of the wealth you accumulate, can be a noble pursuit. It is the attempt to get rich quickly that is doomed to frustration and futility. The Bible says it best in Proverbs 13:11, "Dishonest money dwindles away, but he who gathers money little by little makes it grow."

There is nothing wrong with investing. There is a great deal wrong with gambling and speculation. I have long theorized that if we were to hook up medical monitoring equipment to someone at a casino in front of slot machine or a roulette wheel, and then hook the same equipment up to someone sitting in front of a computer who was day-trading stocks, we would find that the physical and emotional responses would be virtually identical. There should be a vast difference between investing and gambling. Sadly, so much of the time for so many people there is no difference at all.

Getting Off Of The Rollercoaster

One of the more absurd things that brokers will often say to their clients (usually after the client has lost a pile of money!) is, "You can't let yourself get emotional about your money." What an arrogant, ridiculous thing to say. First of all, it isn't his money so it's pretty easy for him not to be emotional about it. Secondly, that money for you is not just a big pile of green stuff – it represents work and sacrifice in your past and security and hope for your future. It is easy not to be emotional about green colored paper … it is an entirely different matter to not react emotionally to the loss of something that represents the retirement you long for and the legacy you want to leave behind.

Our emotions have something to do with why we often fall prey to the financial pornography that causes us to get caught up in harmful speculation. By focusing on the retirement planning strategies that you will read about in the pages to come, you can help yourself become like the person sitting in their airplane seat with a good set of music headphones, enjoying the music while drowning out the unwanted background noise.

[1] Charles Mackay, Extraordinary Popular Delusions and the Madness of Crowds (Harriman House Classics 2003), p. 65 & 71.
[2] John O'Farrell, An Utterly Impartial History of Britain - Or 2000 Years of Upper Class Idiots In Charge (October 22 2007) (2007, Doubleday)
[3] Charles Mackay, Ibid.
[4] Edward Teach - CFO Magazine (May 1, 2007). The Bright Side of Bubbles.
[5] Salsman, Richard M. "The Cause and Consequences of the Great Depression, Part 1: What Made the Roaring '20s Roar", *The Intellectual Activist*, June, 2004, p. 16.
[6] Jonathan R. Laing, "The Bubble's New Home". Barron's Magazine. June 6, 2005.
[7] Block, Ralph, *Investing in REITs: Real Estate Investment Trusts*. Bloomberg Press. p. 268, January 1, 2006.
[8] Financial Analyst Journal, "Determinates of Portfolio Performance," May/June, 1991.
[9] Wellington, Weston "How Not To Retire Rich." June 24, 2008, www.dfa.com