CHAPTER 62

DISPELLING THE MYTHS OF WALL STREET

BY MARK H. WITT

INTRODUCTION

The crowd eagerly awaits the emergence of the star from backstage. The moment has arrived. The roar is deafening as he walks on stage. No, I'm not at a Kenny Chesney concert. I'm at a Broker Dealer conference with hundreds of my colleagues, fellow investment advisors. We await a *rock star* money manager to espouse his philosophy on how to "beat the market." And beat the market he has done. For the previous decade he was ranked as one of the World's Best Money Mangers. With the retail mutual fund industry in decline, the ability to partner with the world's best institutional money managers is intriguing.

The well-dressed gentleman confidently walks onto the stage. He has the presence of Paul Harvey. There is an air of sophistication as he speaks. He travels the world in search of the best stocks. He manages money for some very powerful and influential people. We learn firsthand about his money management philosophy; a system based on extensive quantitative research and technical analysis. His tactical portfolio practically guarantees *participation in bull markets while avoiding participation during inevitable market downturns*. It's as though he has discovered the magical formula that ensures investing success: exceptional profits in rising markets and a knack for avoiding losses in down-market cycles.

Trouble is this *rock star* manager fell from the top echelon of his profession to mediocrity in the span of two years. He was unable to duplicate his past heroics. The magic was gone. He did not have a crystal ball nor had I found the holy grail of investing. So one day I called his office to talk about his firm's dismal performance. He gave me a number of excuses from monetary policy to extreme weather patterns (yes, he even blamed the weather). My response was "you are willing to take credit when returns are outstanding but are unwilling to accept responsibility when returns are negative." And I will never forget his answer: "Listen, we can't get it right every time. Deal with it."

Intellectually I already knew the truth: no one can *consistently* predict the movement of the stock market. And, at that moment I began a relentless journey to discover the truth in investing. Stay with me for a few minutes and I will reveal the fundamental principles to becoming a confident successful investor.

RETURNS COME FROM THE MARKET NOT THE MANAGER

Admit it. You want to find the next "genius" to manage your money. Who wouldn't? Peter Lynch's record as Fidelity Magellan's manager still stands as the most remarkable in mutual fund history. While other fund managers have gone on notable streaks, nobody can touch Peter Lynch's run – not before, during, or since. Lynch was one in a million.

According to John Bogle in *Common Sense on Mutual Funds: "*roughly 80% of all mutual fund managers fail to even meet the return of the S&P 500 every year, let alone exceed it." The other 20% can't sustain their above average performance for more than a few years. If mutual fund managers with graduate degrees in finance from Wharton or Stanford can't beat the market, do you really think you can?

Investors must realize that true stock market returns are realized by owning a highly diversified mix of assets across multiple asset classes on a global scale and **not** by constantly trying to find a mutual fund manager who is all too willing to prove his investing prowess with *your* money.

My investing philosophy is simple, yet powerful. We design portfolios using structured engineered asset class funds. We purchase institutional class funds only. These funds are typically available only to the most sophisticated investors. These funds buy a cross-section of stocks in any given asset category, and often employ highly effective trading strategies to minimize trading costs to the portfolio.

Check out how generous market returns can be:

- U.S. Micro Cap stocks, 12.26%; 1927-2012
- S&P 500 (Large U.S.), 9.82%; 1927-2012
- Small Cap Value, 14.77%; 1927-2012
- Large Value, 11.64%; 1927-2012
- International Small Companies, 14.40%; 1970-2012
- International Large Companies, 9.06%; 1970-2012

Quit looking for the next Peter Lynch. Returns come from the Market not the Manager!

WHY MARKET TIMING IS A BAD IDEA

So you want to be *in the market* when equities are soaring and *out of the market* when equities are falling? Etch this in your memory: For a market timing approach to succeed, you must be correct *twice*… when you leave the market **and** when you get back in. Time and time again studies show that investors who try to second-guess the market's direction will get burned. Market timing is any attempt to guess the direction of the market. Remember the *rock star* manager? His sales pitch was: *our tactical portfolio will participate in bull markets and avoid participation during inevitable market downturns.* Reread that last sentence. Does that sound too good to be true?

"After nearly 50 years in the business, I do not know of anybody who has done it (market timing) successfully and consistently. I do not even know anybody who knows anybody who has done it successfully and consistently" – John Bogle, Founder of Vanguard Funds.

From 1991-2010 a Dalbar Research study found if you stayed fully invested in large U.S. growth stocks, a $100,000 investment would have grown to $565,610, a 9.05% average annual gain. **If you just missed the best 30 days, over the entire twenty-year period, your rate of return now drops to 0.85%.**

Another market timing ploy is the product sale. Instead of just guessing when equities are good or bad, financial firms push the hot product. You've heard the pitch…you need to own precious metals, commodities, hedge funds, managed futures, REITS, or variable annuities. Never buy financial products on impulse or just because they are the hot product. This is merely market timing in disguise.

So this idea of timing the market – trying to guess when stocks are hot, when they're not, is one of Wall Street's worst ideas, EVER! If you want all the profits you must be invested all the time!

RETAIL VS. INSTITUTIONAL

You may not be aware that there are actually *two* mutual fund industries. You're well aware of *retail* mutual funds, but you may never have heard of *institutional* funds.

According to David Swenson, chief investment officer of Yale University's $20 billion endowment fund, there is "overwhelming evidence that proves the failure of the retail mutual fund industry."

When my company decided to leave the retail mutual fund world, it was a relatively easy decision. Today the industry is more concerned with making profits for itself than serving its shareholders. Retail mutual funds have two glaring problems: high fees and poor performance.

Institutional funds have numerous advantages over retail mutual funds:

- Institutional funds rely extensively on an academic approach to money management
- Institutional funds are engineered and structured for true asset class performance
- Institutional funds are designed to capture market rates of return over multiple asset classes using extensive global diversification
- Institutional funds generally have lower fees
- Institutional funds generally produce higher rates of return

Because my company is a Registered Investment Advisory firm, we have access to institutional funds. We consider Dimensional Fund Advisors (DFA), to be the best institutional fund family. With $315 billion currently under management, DFA's list of clients includes high net worth individuals, public funds, major corporations, Taft-Hartley funds, and non-profit organizations. Individual investors can only access funds managed by DFA through authorized financial advisors. In the United States, there are a small number of advisors who have completed the training necessary to be approved by DFA. I am happy to say that my firm is an approved provider of DFA funds.

THE WALL STREET MARKETING MACHINE

The year is 1979. John Houseman, the actor with a distinctive mid-Atlantic English accent is sitting in an elegant restaurant. Lights! Camera! Action! It's a commercial for Smith Barney, the Wall Street investment firm. John Houseman proclaims "Smith Barney makes money the old fashion way…They earn it!" I remember that commercial like it was yesterday. In that brief 30-second commercial, America knew Smith Barney meant business. Invest your money with Smith Barney. We will make you wealthy at Smith Barney.

Ladies and gentlemen, therein lies the danger. America was duped by an actor with an English accent. America would invest their hard earned money with a Wall Street firm because Madison Avenue advertising executives had created an award-winning commercial that caught our attention. Let me introduce you to a very dangerous adversary: the Wall Street Marketing Machine.

Wall Street is everywhere. Its marketing reach is limitless. According to Joshua M. Brown, author of *Backstage Wall Street,* the securities industry spends $15 billion a year in advertising. To put that number in perspective, the alcohol and beer industry spends only $2 billion per year. There isn't a televised sporting event in the country that doesn't count a financial firm as a sponsor. There isn't a newspaper in the nation that doesn't count on at least some ad revenue from a fund company, brokerage firm or bank. There is a common theme that runs through all investment marketing: "We know what we're doing in the market." It's outrageous to think we can be manipulated by their advertising campaigns. But turn on the TV and there's Sam Waterston, straight from the set of Law and Order, pitching investments for T.D. Waterhouse and there's E-Trade Baby….isn't he cute? And just for fun let's throw in the 24/7 media, talking heads on TV, radio, the Internet, books, magazines, newsletters, smart phones, oh my gosh, make it go away! You can't even go to the gym or your favorite restaurant without ten 60” flat screens blaring out market reports. The Wall Street Marketing Machine is here to stay and it’s only going to get worse.

Studies of neuroeconomics show that emotions drive investment decisions more than objective data. I can tell you exactly how to invest your hard-earned money to maximize your returns and minimize risk. My recommendations will coincide with the finest minds in finance today, backed by reams of academic studies. You will agree that this long-term disciplined approach is right for you. But the Wall Street Marketing Machine will try to convince you otherwise through slick advertising campaigns.

It’s a fact that most people don’t respond to reason when it comes to investing decisions; they allow their emotions to get in the way. The Wall Street Marketing Machine knows this so they feed us what drives us to act—the feelings of fear and greed. **Do Not Let The Wall Street Marketing Machine Control Your Mind and Emotions.** Turn off the noise. Prudent investors win. Emotional investors lose. Period.

THREE SIMPLE RULES TO INVESTING

The diet industry is a multi-billion dollar industry. They trot out the latest and greatest ways to lose weight but really there are two simple rules for weight loss: Eat Less and Exercise More. Simple rules – but not necessarily easy to follow.

The financial services industry is a multi-trillion dollar industry. They would have you believe that investing is complicated but in reality it is simple. There are three rules to investing. Let’s break down each rule, see what it means, and why it is so critical for your success.

Rule #1: Own Equities

Equities are the greatest wealth creation tool known to man. Since 1927, an investment in the S&P 500 has produced an annual rate of return of close to 10%, while stocks of small and value companies have produced returns of 11% to 14% during this same timeframe.

Our institutional portfolios consist of 12,000 stocks spread over multiple asset categories and adhere to the landmark research of two distinguished professors of finance: Eugene Fama and Kenneth French.

Fama is widely recognized as the "father of modern finance" and is the distinguished professor of Finance at the University of Chicago Booth School of Business. French is the distinguished professor of Finance at the Tuck School of Business at Dartmouth College. The Fama-French Three Factor Model is considered the gold standard among Nobel Prize laureates in economics. The three factors involve owning domestic and international equities across multiple asset categories, global exposure to small company stocks and global exposure to value stocks. We strictly adhere to the Fama-French Three Factor Model. (Fama was awarded the 2013 Nobel Prize in Economic Science, a validation of his rigorous work in finance and investment management.)

Warren Buffet once said, "In the 20th century, the United States endured two world wars and other traumatic and expensive military conflicts; the Depression; a dozen or so recessions and financial panics; oil shocks; a flu epidemic; and the resignation of a disgraced president. Yet the Dow rose from 66 to 11,497." (And the Dow has risen above 16,000 since Buffet's quote.) Intelligent investors who believe in capitalism and focus on equity ownership, have been richly rewarded over the past century.

Rule #2: Diversify

While reviewing a portfolio from a Wall Street firm a few years ago I noticed a major flaw. The account held twenty-three mutual funds but was largely allocated in only three market sectors. The flaw…lack of diversification. What is diversification? Too often investors believe that owning a bunch of "stuff" means true diversification. However, true diversification is owning distinct asset classes across multiple lines of investment sectors, with an emphasis on correlation, a statistical measure of how two securities move in relation to each other.

My company partners with Matson Money and Dimensional Fund Advisors to provide institutional portfolios for our clients. Mark Matson, CEO of Matson Money a $4.7 billion dollar investment firm was once in a meeting with Nobel Prize winner Myron Scholes. Mark commented that our institutional portfolios are "as diversified as a Fortune 500 pension plan with billions in assets." Myron Scholes interrupted with, "That's not accurate. They are better diversified." A ringing endorsement from a Nobel Prize winner for our diversification model!

Our portfolios include stocks in 45 countries. Here's a list of free market economies that are included in our institutional portfolios:

Argentina, Australia, Austria, Belgium, Brazil, Canada, Chile, China, Columbia, Czech Republic, Denmark, Egypt, Finland, France, Germany, Greece, Hong Kong, Hungary, India, Indonesia, Ireland, Israel, Italy, Japan, Malaysia, Mexico, Netherlands, New Zealand, Norway, Peru, Philippines, Poland, Portugal, Russia, Singapore, South Africa, South Korea, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, United Kingdom, and the United States of America.

Pretty cool, huh? Your money is invested in all of these free market economies! Now that's Diversification!

Rule #3: Rebalance
Rebalancing is a way to ensure your portfolio is no more or less risky than you intend. To give an example, if the equity portion of your portfolio increases in value more than the bond portion, you have a riskier portfolio than the one you created because the allocations to stocks is now higher. The simple solution is: sell some stocks and buy more bonds to bring your asset allocation back to target.

Rebalancing forces you to do the opposite of what you think you should do. Emotionally you want to buy more of the asset that rose in value and sell the asset that under performed. Here's a great example: in 2008 long term government bonds rose 26%. Small U.S. stocks fell 37%. Human nature would say buy the bonds that are up 26% and sell the stocks that are down 37%. That would have been a huge mistake because in 2009 the bonds fell 15% and small U.S. stocks rose 47%.

Ever heard the expression *buy low and sell high*? That's exactly what rebalancing is and if you're not rebalancing your portfolios on a regular basis, you certainly are at risk of losing potential market gains.

SUMMARY

Wall Street and the 24/7 media want you to believe they have all the answers. So, why have the majority of investors lost faith in Wall Street? <u>Investor Alert:</u> It's okay to lose faith in the Wall Street institutions. They deserve it. But never lose faith in the *stock market.* Your investment in the *stock marke*t provides capital to businesses around the world to provide the products, services and technologies to make the world a better place. Just remember three simple rules... Own Equities, Diversify and Rebalance. Follow these rules and you will be in an elite group of investors who have confidence, clarity and peace of mind.

About Mark

Mark H. Witt is the President of Witt Financial Group, LLC, a Registered Investment Advisory firm. With over fifteen years of experience in the financial industry, Mark dedicates himself to working with investors who are interested in learning how financial markets work and are seeking a disciplined approach to investing.

Mark's approach to investment management is the culmination of years of study grounded in academic research from the University of Chicago. Mark teaches his clients the truth about how Wall Street really works and educates them on how they can achieve true peace of mind and win at the investment game. Mark wants each client to achieve clarity and confidence on their financial journey.

As a dynamic public speaker, Mark has shared his message of free markets and global investing with thousands of people around the country. His direct approach and enthusiasm make him a compelling speaker and fierce proponent of free market capitalism. Mark currently teaches public and private seminars on Investing, Asset Allocation and Modern Portfolio Theory.

Mark co-hosted "Main Street Money" which aired on Public Broadcast System (PBS) in 2012. Mark was featured in the documentary *Navigating the Fog of Investing* and has appeared on *Matson Money Live!* – a popular Internet financial show.

Mark and his wife, Glenda, have been married since 1983. They have two sons, Jordan and Grayson. Jordan graduated from East Tennessee State University and is Vice President of Witt Financial Group, LLC. Grayson, a beautiful child with special needs, is an active participant in Special Olympics.