



Longbranch Research Associates presents:

# So-Called Experts

*a book always in progress & free*

by Stephan Michelson

## Chapter 8

### Investing

*as of December 25, 2016*

In Chapter 7 I suggested that you define “investment” to cover your entire financial future, perhaps committing yourself to some activity in which you can put time as well as money—if you have the time and the ability to use it productively. I stressed that few financial managers will produce a better net result for you than you can get on your own. Many are simply bad. Others aren’t expert enough to cover what they charge you. Some that are will not accept you as a client. To get you a 7 percent return, a manager has to make over 10 percent. Suppose you can make 8 percent on your own. You are only four-fifths as good as such an “expert.” But you are also wealthier than he or she would leave you.

Some so-called “experts” are disasters. Merrill Lynch left Orange County, California, bankrupt in 1994. Bernard Madoff left many clients bankrupt, and went to prison for it. Goldman Sachs advised Greece to issue bonds, while warning its clients not to purchase them. I had an account at UBS, a Swiss brokerage (the Swiss surely are experts at this, I thought) in which UBS insisted that I purchase what they recommended. I went along with it for a few months. *Every* stock I purchased on my own during that time—into another account—did better than *any* stock they put into my portfolio. Expertise like theirs I do not need.

### Investing vs. Trading

One attribute of many so-called experts is that they denigrate other so-called experts. This is Nassim Nicholas Taleb:<sup>1</sup>

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<sup>1</sup> Nassim Taleb, *Fooled By Randomness* (2<sup>nd</sup> edition, Random House, 2005), page 104.

Even some experienced trading veterans do not seem to get the point that frequencies do not matter. Jim Rogers, a “legendary” investor, made the following statement:

I don’t buy options. Buying options is another way to go to the poorhouse. Someone did a study for the SEC and discovered that 90 percent of all options expire as losses. Well, I figured out that if 90 percent of all long option positions lost money, that meant that 90 percent of all short option positions make money. If I want to use options to be bearish, I sell calls.

Visibly, the statistic that 90% of all option positions lost money is meaningless, (i.e., the frequency) if we do not take into account how much money is made on average during the remaining 10%. If we make 50 times our bet on average when the option is in the money, then I can safely make the statement that buying options is another way to go to the palazzo rather than the poorhouse. Mr. Jim Rogers seems to have gone very far in life for someone who does not distinguish between probability and expectation.

Taleb seems to think that no one before him has recognized the difference between the probability of an event and its expected value:

$$\text{Expected Value} = \sum w_i * (p_i * \text{outcome}_i)$$

That may look scary, but it is simple:

- Multiply the value of each possible outcome ( $i$ ) by the probability that it will occur ( $p_i$ ).
- Weight each outcome by the proportion of total funds invested ( $w_i$ ). (The weights will sum to 1.00.)
- Add them all up (that’s what “ $\Sigma$ ”, a capital Greek sigma, means).

Each  $p_i$  will always be less than 1, except for U.S. government bonds, which are sure to pay their nominal value back ( $p_i = 1$ ), even if they are worth less in real terms than you paid for them. The secret of his success, Taleb says, is that “I aim at profiting from the rare event, with my asymmetric bets.” His premise is that markets undervalue low-probability events, but low probability events do occur, so that even if you lose most of the time, when you win you win big—big enough to make the strategy pay. Even if you have the probabilities correct, Taleb argues that to apply an “expected value” calculation to this strategy seems not to understand it.

The real value can be large even if the expected value is small, if a few outcomes are large enough, and you hit on some of them.

I agree that markets assess probabilities incorrectly.<sup>2</sup> The notion that markets are always right is not only empirical nonsense, it contradicts the concept of expertise. It contradicts the idea of a market with both buyers and sellers. The question isn't whether Taleb is correct about that, but whether that information helps you. Without a massive bankroll, you will not have enough observations to be able to rely on a mathematical average, and Taleb does not. The real backbone of Taleb's "method" is his belief that these probabilities are not correct, that low probabilities are not really as low as people think. Low probability winners, he says, are priced too low. He may be right, but are you going to bet your portfolio on it?

Was it in 2004 or earlier that Jim Rogers started to say "just buy commodities"? Buy copper, buy soybeans. Had you bought copper or copper futures or copper miners when Rogers was telling you to, you would have done well. That you can make more money on ten percent of your options than you lose on 90 percent—Taleb's approach—only helps if you have in fact bought into the ten percent of winners. Even Taleb does not claim to know in advance which ones they are, or he would not stop at having them be only ten percent of his trades. Taleb wants us to buy into long-shots because, he says, they are worth more than their price—on the average. Rogers is saying why not use your knowledge of the world around you to buy things whose prices are clearly going up, like commodities? Why not bet with the probabilities, instead of against them?

Which path should we follow? Jim Rogers'. Indeed, which path *can* we follow? We do not have enough money to bet on large numbers of trades, most of which are losers. Not even buying options, which cost pennies compared to the stocks they will allow you to buy for dollars. Taleb is a trader. Jim Rogers is a smart investor. Taleb is not wrong; he simply does not give us mortals practical advice. Rogers does. For some reason Taleb is seen as something of a Wall St., guru. I think he has nothing to say to you and me.

Here is another view of the utility of making decisions from expected value, not probabilities, from the Kaplans, whom we will meet again. They are discussing the impact of the "prior probability" in Bayes' Theorem:

This means our assumptions about forecasting a given event  
are based on the intrinsic accuracy of the forecast times the

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2 You can read about the debate on this point by looking up Eugene Fama in Wikipedia.

intrinsic likelihood of the event itself. So when an event is likely (rain in Bergen), an accurate forecast has a favorable effect on our assumptions. When the predicted event is unlikely, though, it drastically reduces our reasons to believe in any forecast, however accurate.<sup>3</sup>

Taleb wanted us to realize that the improbable is more probable than the market thinks it is, although, even if he is correct, we can go broke acting on it. The Kaplans warn that one can go far wrong assuming the improbable is impossible, such as when a weather forecaster ignored a citizen's direct observation of an impending storm. And that is why I will extol the use of specific on-the-ground information that you may obtain in your daily affairs. Ask the UPS driver how busy he is now, compared with last month. His answer may be a better guide to investment than any information you can get from an "expert." However, that does not recommend the improbable as an investment strategy, either long (thinking the improbable will occur) or short (thinking it certainly will not).

There is always a trade to be made betting that an up market will go down. Some day it *will* go down, even though when the market is going up, those down days are rare. So we should always bet on up when the trend is down, and on down when the trend is up? This strategy will produce some but infrequent wins, and an overall loss. Being contrarian is not enough. As Taleb indicates, we have to be contrarian when the betting is *overwhelmingly* against us, when either the probability or the value of our bet is not appreciated by others.<sup>4</sup> Until then, we need a different strategy, one we can effectuate with some safety.

Stanley and Danko tell us that few millionaires inherited their wealth, most of them are frugal, most manage their own stock portfolios, and over 90 percent hold an investment for more than a year.<sup>5</sup> A large proportion are entrepreneurs, and most list their accountant as their primary financial advisor. They want the numbers to be right. They make their own investment decisions, and do so for the long haul.

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3 Michael and Ellen Kaplan, *Chances Are* . . . , Viking, 2006, at page 224. Despite their favorable reviews, my impression is that the Kaplans barely (if at all) understand what they are talking about. They seem to think that "expertise" is the ability to translate generalities into examples that the reader will find familiar. I would agree, if the examples accurately illustrate the generalities, and if the generalities are worth understanding..

4 Taleb claims to have told us how to trade this way in *The Black Swan: The Impact of The Highly Improbable*, Viking, 2007. This book is just a rehash of recommendation to bet on the improbable, without any hint how actually to do it. Ask yourself how likely you are to have information that no one else has. If the answer is "not likely," then Taleb is asking you to guess. That is not the basis of successful investing.

5 Thomas J. Stanley and William D. Danko, *The Millionaire Next Door*, Longstreet Press, 1996.

The Jim Rogers approach is to use your knowledge of the world to find areas in which investments are likely to pay off. I recommended the same approach if you want to consider rental property in your investment portfolio. If China and India are going through industrial revolutions, then let's look at what has happened in such times, and assume those things will happen there, too. Rural inhabitants will move to the city where most will remain indigent, guaranteeing low priced unskilled labor far into the future. Buildings will be built, businesses will be formed, a market economy will become established, which includes a financial sector. The central city will expand, which is to say that fringe areas will increase in value, eventually.

We know that the people who made money during our 1848 gold rush were not the prospectors flooding to California, but merchants who sold goods to them. We may not know which Chinese construction company will succeed, but they all will need pipe, cement, faucets, light switches, etc. And as we do not know who will make these things, the one sure bet is that there will be demand for the material from which they are made. That was Jim Rogers' logic behind buying copper. Until China's expansion slowed, good logic it was.

Roger Conrad at *Canadian Edge* told us that no matter which company in Alberta, Canada is most successful at producing a liquid fuel from tar sands, that fuel will be transported by the Pembina pipeline. You may do better if you can assess the individual tar-sands producers, but most of us cannot do that. We should buy Pembina (as I have). One could similarly see that regardless which producer gets the next large contract for low-sulphur coal in Montana or Wyoming, a railroad will carry it. Find out which one, and invest in it, unless you think coal is dying quickly and will take the railroad with it. Jim Cramer admitted that he was late to see the value in petroleum shippers.<sup>6</sup> Following the Rogers-Conrad approach, I had been buying shippers along with oil companies and pipelines for years. By 2012, we were both wrong. When the shipping stocks no longer returned what I wanted, I sold them. You do have to keep on your toes.

The low stock trade commission structure we now live in—a trade that used to cost hundreds of dollars now should cost under ten—invites one to join the Cramer ethos in which there is only “buy” and “sell,” but no sound effect button or graphic for “hold.” If you have mad money, you are welcome to throw it into Jim Cramer’s world. It’s just not what I am writing about here. I do not consider any of my money available for gambling, even informed gambling. Let’s keep talking about investing.

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<sup>6</sup> Jim Cramer, “Mad Money,” CNBC television. This statement came on July 9, 2007. On the other hand, he advocates following the Baltic Dry Shipping Index as an indicator of economic activity. I agree.

## Brokerage Account

Open a brokerage account. Most brokers offer a checking account. Use it. Put some cash in it, and instruct the brokerage to put your dividends in it. You will reinvest dividends, but not necessarily in the same company that paid them. Save them until you spot a stock to buy that will improve your portfolio.

Do not select a broker because they give you advice. On the left is an example

Ticker/Name	Ratings
<b>Equities</b>	
BGF B & G FOODS INC ...	NC
CZN CITIZENS COMMUNICATI...	A
IGR ING CLARION GLBL RE ...	NC
IWA IOWA TELECOMMUNICATI...	D
MTR MESA ROYALTY TRUST	NC
OTT OTELCO INC ...	NC
RCS PIMCO STRATEGIC GLOB...	NC
SPH SUBURBAN PROPANE PRT...	NC
TPP TEPPCO PARTNERS L P	NC

why. In June, 2006, these are stocks I held in an Individual Retirement Account (IRA) at Schwab. This is a screen shot, Schwab's listing of the trading symbol, the name, and Schwab's rating. All but two are "NC," which means Schwab does not cover them. Schwab will tell me other companies' ratings, but has none of its own on these stocks. Of the two equities they cover, they rate one highly and one poorly. Yet on the day of this screen shot both were selling for a dollar a share more than I had paid for them; and although CZN's dividend gave me a 8.3 percent return on my investment, IWA's yield was 9.4 percent.

now that it's more expensive? I don't see it that way.

One month later, IWA's price had increased further, and Schwab had increased its rating from "D" to "C." You mean it's a better buy

The ratings difference must be either that CZN is expected (by Schwab) to grow faster (although it has not since I purchased it), or IWA is riskier, which must mean its price is more likely to fall. I do not know why they would think that, and indeed both have continued to increase in price.<sup>7</sup> I could get more information from Schwab about their rating, but, as you see, I ignore it. I use Schwab as a service agency. I do not look to them for advice and, if I did, by and large (given the difference between the stocks they cover and those that interest me) I would not get any. Evaluated for their service, however, they are a near unanimous favorite for your first account.

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<sup>7</sup> Citizens Communications became or was purchased by Frontier Communications, FTR, which does the same thing—own land-based telephone lines. I will describe below what happened to IWA.

Here is one thing I like about Schwab's service, something you would not notice while shopping around. When you buy a stock, it appears in your account immediately, and the money you used to buy it disappears from your account. When you sell, the money is added to your account immediately, and the stock remains in your account but with zero shares. This is not totally accurate accounting, but it is helpful accounting.

You will not actually own a stock you "purchased" today for three more business days, and your money will—even at Schwab—remain in your account and earn interest during that time. If you sell, Schwab will not actually have the money for three days, but you can use it to purchase other stocks because of the three-day delay in effectuating *that* trade. If you purchase stock, cash is committed to that purpose. The instant accounting, the disappearance of that cash from your record, reminds you that it is committed and not available to you. Schwab's accounting reflects how I think—that I have spent that money, it is gone—not the institutional idiosyncrasies by which, absurd in this computer age, sales are not recognized, money not transferred, immediately. I appreciate Schwab's implicit view, because it is my own, even though, strictly speaking, it is wrong.

Most other brokerages use a negative entry to indicate that these funds are still in your account, but are committed or "encumbered." Fidelity will show you the amount you have in your cash repository (a fund) at the top of the page, and place an entry at the bottom of its page: "You have **\$whatever** in pending activity." They leave it to you to do the math, and also to figure out what that activity is.

## Goals

Any investment advice book will ask you about your goals. Who would not say: My goal is to accumulate as much wealth as I can? Risk enters the picture at just this point: The higher the probability of making more money, the higher is the probability of losing it all. The intent of the question is for you to rate yourself on a risk scale. The UBS broker told me that if I declared myself to be risk averse, he would not be allowed to sell me certain stocks I might want. So I declared myself to be reasonably risk tolerant. Nothing he recommended met my needs anyway. Then, when he recommended a stock I thought was too risky, he argued "but you declared yourself to be a risk taker," apparently forgetting that he had insisted upon it.

It's like Deepak Chopra tells you: If you do not trust the doctor who is about to cut you open, *do not let him do it*. If you do not like your brokerage company, for any reason, close your account and go elsewhere. That's what I did at UBS.

These overall risk declarations miss the point. You can have a risky part of your account balance as well as a safe part, so that some average “risk tolerance” description of your personality has no applicability to what you are about to do next.

Another problem is not asking what your goal is in the sense of a time-line. Here is Nassim Taleb, again writing disdainfully without offering any verbal palliative:

I will set aside the point that I see no special *heroism* in accumulating money, particularly if in addition, the person is foolish enough to not even try to derive any tangible benefit from the wealth (aside from the pleasure of regularly counting the beans). I have no large desire to sacrifice much of my personal habits, intellectual pleasures, and personal standards in order to become a billionaire like Warren Buffet, and I certainly do not see the point of becoming one if I were to adopt Spartan (even miserly) habits and live in my starter house. Something about the praise lavished upon him for living in austerity while being so rich escapes me; if austerity is the end, he should become a monk or a social worker—we should remember that becoming rich is a purely selfish act, not a social one.

Taleb is referring to the millionaires described, and in some part interviewed, in Stanley and Danko's *The Millionaire Next Door*, cited above. Those authors make an elementary but correct point that we often confuse consumption (flow) with wealth (stock). The “millionaires” may not be who we think they are, because they are not all ostentatious. They are not all (not even mostly) cloistered in compounds of the wealthy. You may live near them, especially if you are reading that book, or Taleb's, or this one. And if your lifestyle is OK, then so are theirs.

Taleb concludes that these hidden millionaires are “not even” trying “to derive any tangible benefit from the wealth (aside from the pleasure of regularly counting the beans).” This is nonsense. I bought a house in Takoma Park, Maryland, and started my statistical analysis business, both in March, 1979. I started immediately to increase the size of the house, ripping off the roof and building it up one story, while taking up the livingroom floor so that the basement became the new two-story livingroom. I paid myself \$55,000 a year. It took ten years to pay off the second mortgage that supported the renovation, and fifteen to pay off the first that supported the purchase. I lived in that house, one a \$55,000 annual salary could support, for about fifteen years. During that time, my statistical analysis business having been successful, I became the millionaire next door. My life style hardly changed. Oh yes, I did buy a car in 1986 (until that point I had only a motorcycle), a new Toyota

Cressida station wagon, my only automobile for the next twenty years. The Cressida and its successor, a 2006 Subaru Forester, are good cars, damn it. I saw no reason to expend my increased wealth on a “better” one.

I earned, I saved, and now I live on the returns from those savings. My life style was and remains comfortable and reflective of my values. Indeed, it remains essentially unchanged, but hardly austere.

This notion that, while accumulating wealth, you need not (and many do not) *greatly* increase your consumption, generates strange reactions. *Money* magazine, in its August, 2008 issue, quotes Professor Meir Statman on *The Millionaire Next Door*:

. . . the idea that I have to live like a pauper even if I have the means to live better doesn’t make any sense to me.<sup>8</sup>

Obviously he never read the book he says he is reacting to, as it says nothing like that. It says that many people, while accumulating wealth, prefer to save and invest it, rather than spend it. I highly suggest that frame of mind. Not that I have Professor Statman’s expertise, mind you . . .

Like Statman, Taleb could not be more wrong, or less insightful. “Becoming rich”—rich enough to own property and pay its taxes, to buy groceries and gasoline and health care, and not be a burden on anyone—is indeed a social act. Bill Gates and Warren Buffet—who give away billions of dollars—demonstrate the possibilities, although they are uncommon. I can and still do work, because I enjoy it. I do nothing in desperation or fear. Living on a wooded mountain, I have to trap an occasional raccoon (those that learn how to enter the cat door to eat the cat food), avoid the deer and wild turkeys in the road, and just stay inside when mama bear takes her cubs for a stroll. I could bore you even more with an encomium about well water, compared with chlorinated city water. But enough: I live the lifestyle I dreamed about while living a perfectly reasonable suburban life, even eventually increasing my salary. I am able to do so now only because I lived well below my income’s possibilities then.<sup>9</sup>

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8 Meir Statman, the Glenn Klimek Professor of Finance at the Leavey School of Business, Santa Clara University, in *Money*, Volume 37, Number 8 (2008) at page 120.

9 My view is not unique. See, for example, [www.dividendgrowthinvestor.com](http://www.dividendgrowthinvestor.com). As implied by its name, the advice on this site is to invest in companies that increase their dividends, not necessarily those that appear to pay high dividends when you purchase. You have less cash flow at first, but more later.

## Risk

Although I have used the word “risk” as if you and I both know what it means, I do not and I think no one does, in investment. Climbing a shear rock face with no safety rope is risky, as you know when you do it. Better yet, you know it when you see someone else do it. Driving while intoxicated is risky even if, being under the influence, you do not know it while you are doing it. What we mean by “risky” in these circumstances is “more likely to fail” than some other, safe activity. More likely to have a bad outcome.

John Cassidy tells us that he purchased stock in British Telecom (BT) in 2001.<sup>10</sup> “Five years later, the stock is trading well below the price I paid for it, and I still own it.” After describing neuro-science, a study of neuron activity under risk taking situations, Cassidy continues:

In fact, people often have only a vague idea of the risks they face. Consider my investment in BT. Back in 2002 there was no way that I could have predicted how much profit the company would make in 2006, let alone in 2010 or 2020.

Psychologists run experiments that ask us to choose between a risk situation (say, an equal chance of making or losing \$10) and a sure thing (say, \$3). Such an experiment does not reflect the real world decisions we must make. In layering your assets to have some more liquid (and sure) than others, you may well consider some form of federal guarantee, such as in an insured bank account, a value. Most of your decisions, however, are between different risky possibilities. If only you could measure *how* risky they were!

In this real world, we use proxies—the history of the company, the reputation of its officers—to assist our assessment. Then we learn that the CEO of United Healthcare has resigned because he back-dated stock options, as did many other corporate officials in many other corporations. Perhaps the only sure thing is that people will not only steal if given the chance, they will expend considerable effort to get that chance. This does not help us assess risk in choosing a stock.

Pictured below is the daily BT stock price since January 1, 2001. It is true that Cassidy lost value if he purchased that stock in that year, but it has more or less held its own since 2002. During all that time, it paid a dividend. If risk is the likelihood that one would lose *everything* (as, for example, falling from a sheer cliff),

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10 John Cassidy, "Mind Games," *The New Yorker*, September 18, 2006, page 30, subsequent quotation at 32.

there never was much risk in this stock. That is how I will use the word “risk.” It is the probability that you have purchased Enron, that your investment will be worth nothing by the time you have a chance to get out.



In my terms, Cassidy confuses risk with uncertainty. He does not know how much BT will make. That's uncertainty. But he can be just about certain that he will not lose all of his investment. Technology has worked in BT's favor. With the surge in demand for cellular phones and internet lines, BT did well for a while. It might not have, that's uncertainty, but it was never a risky investment, never likely to fail completely. An analogy today would be AT&T or Verizon, both of which pay dividends. They may or may not be stocks you want to own (I own both). They may or may not increase their dividends, or increase in price over time. But you will not lose your entire investment if you buy these companies.<sup>11</sup>

Nate Silver, famous for his accurate election predictions, similarly wants to distinguish the “closeness” of an outcome—how close it is to being different—from the precise quantitative score that will bring that outcome about.

The distinction that got lost a bit [in the 2012 election] was between closeness and uncertainty. If a baseball game is 3-2 in the bottom of the 9th inning and you've got Papelbon on

11 John Maynard Keynes also distinguished risk from uncertainty, but used the words in the opposite way from me. Sorry for the confusion. Here is an explanation of Keynes' meaning:

[Risk] exists when the future can be predicted on the basis of currently existing information . . . ; uncertainty exists when no reliable information exists today about future outcomes of current decisions.

This comes from Paul Davidson, a founder and co-editor of *The Journal of Post Keynesian Economics*, in a letter to 32 *The London Review of Books* 10, May 27, 2010 at 4. Keynes' “risk” is what I call uncertainty, knowing that there is a distribution of possible outcomes, but not knowing which outcome will prevail. Both risk and uncertainty are dominated by lack of information, but we can be fairly sure that some companies will not fail, even though we are uncertain how well they will do. I prefer “risk” to refer to the possibility of failure, where “uncertainty” refers to not knowing what will happen next, regardless how well one has measured the past. Coca-Cola and Proctor and Gamble, for example, are riskless stocks with uncertain futures.

the mound or whatever, it has definitely been a “close” game but not one in which the outcome is in all that much doubt.<sup>12</sup>

Or, to summarize, close does not mean uncertain (for example, of two stocks, one’s dividend may be only slightly higher than the other), and uncertain does not mean risky.

Cassidy, of course, could not have known the best price at which to buy, or to sell BT. Neither could he have anticipated its erratic dividend history. However, if getting some dividends and not losing it all was Cassidy’s motivation, he did just fine, although, as with my purchase of Southern Company (discussed in Chapter 7), he could have done better. You could do far worse than having a portfolio of only “utilities”—telephone, gas, electric and water companies—which produce things that people will buy in good times and bad.

Not only could Cassidy not assess BT’s prospects in 2002, he still seemed unable to assess them in 2006. And he is a financial expert! Yet brokerages want us to declare our risk preference (they surely mean uncertainty preference) as if, then, the universe of stocks we would buy would be altered, would “fit” us better.

Uncertainty is more related to the information you have about an entity than about the entity itself. The man who marketed the first ant farm sold a million of them in its first year. Who could have anticipated such a demand? Now that over 26 million of them have been sold, next year’s sales are still uncertain, but the business does not look risky. We know that people learn from them, and enjoy doing so, at a rate of about half a million farms a year. We now have the information the inventor did not have. The business itself, however, is exactly the same. Like McDonald’s, the ant farm business may or may not do well in the future, but it will survive. Its future is uncertain, but not particularly risky.

Why did I have three small hard-wire telephone companies in my retirement account in 2006, the era of wireless telephone and VOIP—voice over internet protocol? Why does Schwab think one of them is likely to prosper, another is not? I had them because I ask myself, who is going to bring wireless and broadband to the rural areas served by these companies? I think the answer is: they will. They will become cable, internet and wireless providers, and then be (as they were) absorbed into larger companies. On June 1, 2009, Iowa Telecom and Otelco were paying a

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12 This quotation comes from Nate Silver’s appearance on a sort-of live chat on [Reddit.com](#), as printed in his FiveThirtyEight blog in *The New York Times*, January 8, 2013. He refers to his book, *The Signal and The Noise*, Penguin (2012). His example reveals another truism: facts change. See Neil Greenberg, “Jonathan Papelbon isn’t a closer the Nats can trust,” *Washington Post*, June 7, 2016.

dividend over 13% of their current selling price. In May, 2010, they were paying 9.9 and 10.5 percent, respectively, not because they had reduced their dividends, but because the market was seeing more value in them. Citizens Communication, now Frontier (FTR), has reduced its dividend, and appears to be struggling, although I have not found any information service that predicts its demise. Otelco has suspended its dividend and I have sold it. Both are now risky.<sup>13</sup>

I also own several propane companies, a seemingly declining business as natural gas pipelines spread and compete with much of propane use. As I write, there are over three thousand propane companies in this country. Some will eat the others. The large ones will always have some business, as propane is more portable (and burns hotter) than natural gas. One forklift in my weaving mill runs on propane. I may choose badly (lacking enough information about each company), so there is some uncertainty with individual stocks, but little risk. The future will see more mergers than failures.

For now (2016), for the next ten years, I see not only electric, gas and water utilities, but also small telephone companies and propane companies as good generators of cash flow to me—dividends. The only major uncertainty is that they will be absorbed by firms with more stingy dividend policies. If that happens, I will take what the government leaves me of my capital gains and move on. There is also product price uncertainty. Most propane is refined from natural gas (it can also be refined from petroleum). Raw material prices might rise more than the propane companies can pass them on. Unanticipated ups and downs will occur. I do not see a risk that any propane company listed on a stock exchange will go to zero value before I can act on it, as Nassim Taleb admits that 90 percent of his options do.

Some people are suckered into the stock market on the promise of large, fast gains. I propose that the tortoise approach—slow, steady progress—is both the truly risk averse approach and in general the fastest route to capital accumulation. So why did I dismiss bonds?

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13 On June 2, 2010, IWA merged into Windstream for stock plus cash. Windstream (WIN), similarly, handles land lines that other companies are casting off. Its dividend, at 25¢ per quarter, was about 7.8% in May, 2011, and in August, 2013, is above 12%. That is, its price is falling, the market finds less and less value in it. I am holding on, because I could not get a higher return elsewhere. In 2015 it split itself into two pieces, did a reverse stock split on the piece bearing its name (one share for six), and reduced its overall dividend. Time to sell.

## Bonds

The easiest way to get a stream of money is to purchase it. In a sense, that is what bonds promise. You buy the bond, you get interest payments. Eventually, sometimes before you expect it, the bond is called or redeemed. A young bond may have “call protection”—it will not be snatched away from you for a few years. Older bonds do not have such protection. You will know when it *might* be called, at what price; but you will not know in advance when it *is* to be called, between its earliest call date and its redemption (pay-off) date. One day, you will find, you have cash where you thought you had a bond.

If the bond is called, so-called experts tell you to replace that bond with a bond with the same redemption date. I do not know why. They seem to have some aesthetic view of your portfolio of staggered bond redemptions. Do not replace a called bond with a similar bond. It is *never* right to purchase a financial asset to retain some ideal view of your portfolio.

Let me repeat that, because this is a primary rule, and any proposed act that breaks this rule should be avoided:

Whenever you buy or sell something in your portfolio, buy the best thing for your portfolio, or sell the worst.

Someone who wants you to buy a bond just because you just lost a bond—and especially to buy a bond similar to the one that was just redeemed—is no expert. He/she is following a formula. I prefer actual thought. If you are young enough to wait five, maybe ten years, a solid company that increases dividends regularly will do better for you than a bond even though the bond pays more cash *now* than the stock. What you want to do any time you have cash is the best thing for your portfolio, given its state and the state of the market. It may be to hold the cash, not buy anything, at this time. It may be to purchase property, or pay down debt. It *could* even be to buy bonds. It is never to follow a formula.

## Using your knowledge

Some trends are obvious. In the 1970s, in Washington, DC, there was a long stretch of M St. NW between a built-up commercial area (where I worked at The Urban Institute) and Georgetown, which started many blocks after a bridge. It was obvious to anyone who thinks about the growth of cities that *that* area would also become built up and valuable. Like Massachusetts Avenue in Cambridge, Massachusetts, between Harvard Square and Central Square, or in the other

direction between Harvard Square and Porter Square. Take the rise of property values around universities, for example in Charlottesville, Virginia or Lawrence, Kansas, or from Boston University in Kenmore Square, Boston. The uncertainty is only in how long it would take for these universities to grow, for the market to value land near them. There was never a risk about whether it would happen. Closer to my home, consider US 25 between Hendersonville and Asheville, NC. The area is growing. Land will become more valuable over time, as both of its end cities expand. Property there has uncertain value but, at a reasonable price, it is not ultimately risky.

Where you can get good information becomes the key issue. If you invested in a slide rule company just before the computer chip was invented, you would not immediately have been wiped out. If you held that stock for ten years, you would have been, unless it evolved into a calculator company. But how many calculators do you see today? That company would have had to keep evolving into a computer company, to stay alive. At some point in there you should have acquired the information that slide rules would be gone forever, and that slide rule manufacturers were *not* becoming the calculator and computer companies of the future. They didn't get it. You have to be aware of what is going on in the world to assess the risk of a single piece of it. Like Jim Rogers says, just look around.

Take the large telephone companies. You could easily see that wireless was going to replace many land lines; and a combination of fiber-optic and wireless surely provides better service than old copper wiring. The telephone link to the internet was a passing fancy. Telephone lines just don't cut it. OK, we all knew that years ago.

I figure I'm not that much smarter than the executives of AT&T and Verizon, and I am surely less well informed. They would have to know that wireless and internet (much of which will also be wireless) will decimate the copper wire land line business. But people will not stop talking on the telephone, or sending text messages, or cooking with propane, or using water or electricity. If you buy into the providers of these services, and those companies understand and act intelligently on the trends, you should be all right. Let the land lines and propane heat generate cash, while the telephone companies get into fiber and wireless, and the propane companies merge into general energy providers that pay dividends. Change takes time, and that time is not the risk, it is the advantage you have over people who either do not see the change coming at all, or think it will happen tomorrow.

Ultimately, dividends are my hedge. Sure, there remains the possibility that a company will slash its dividend, but bonds, which are supposed to be less risky in general, also are sometimes defaulted upon. In response to the predicted rise in liquified natural gas (LNG) imports, Cheniere built an importing facility. Then fracking released vast domestic reserves of natural gas. Cheniere converted its import facility to an export facility. Believing management would figure this out, I held its stock through what seemed like a disaster. It is now worth twice what I paid for it, and it has always paid a dividend.<sup>14</sup> Sometimes, for example with Yahoo or Hewlett-Packard, believing that management had foresight or skill would have been a mistake. Then both companies hired new Chief Executive Officers, and we have to re-assess their prospects. That is why Jim Cramer says “do your homework,” although it is not always clear what that means.

## DRIP

A “DRIP” is a Dividend Re-Investment Plan. Its attraction is that, rather than get a cash dividend, you get shares of stock directly from the company, placed into your brokerage account. You buy stock without a brokerage charge, although you will be taxed on the dividend income that you never saw as if it had been cash.

Jim Cramer is asked which is a better strategy for reinvesting dividends: a DRIP or an account into which cash dividends would be placed, for a separate decision to be made on how to invest them. He says the DRIP is the better plan, because compounding (re-investing dividends) is the real power of stocks.<sup>15</sup> A DRIP violates the basic rule of investing. It substitutes an automatic action for a thoughtful one. It commits money to decisions you made in the past, where the basic rule of investing is to commit money to what you think is the best place to put it *now*. In addition, if the company “buys” shares for you on the day before the stock goes ex-dividend, you will pay a higher price than if you purchase the same shares the next day. Cramer is wrong. Don’t let a formula determine how you invest your dividends.

## Measuring Uncertainty

The uncertainty of the future is commonly measured from the past. Calculate the standard deviation (a measure of variation) from the closing stock price every day,

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14 Increased oil from fracking and Canadian oil sands also sent a glut of crude oil to refineries in Oklahoma. The “Seaway pipeline” that had been used to send imported crude to Oklahoma was reversed, so the northern crude could continue south to Gulf refineries. We do not have to think that the executives who made this decision were especially smart, or expert, just that they were not clueless.

15 For example during “Mad Money” on September 2, 2010 or August 5, 2014. He is consistent.

or every week, over some period of time. The standard deviation is a measure of average day-to-day variation in price. To calculate it, type a row or column of numbers in Excel, then go to an empty cell, type

=stdev(

highlight the numbers with your mouse, close the parentheses and press .

A more advanced calculation would be the standard deviation of prices around a trend line, if there is one. That is, if the stock has risen over the period, you do not want to call the difference between today's price and its price last year "variation" in the sense of measuring uncertainty.<sup>16</sup> Do not let this language phase you. You will find a way to do this if you want to. The more important question is: Why should you?

Is future uncertainty really measured from past price variation? Some so-called experts will say so, but that does not seem right. Uncertainty is a measure of the distribution of possible futures, and we call it "risk" to the extent that distribution includes the possibility of complete failure. The future may or may not look like the past.

The current term for price variation is "volatility." It is sometimes measured by the standard deviation of that price calculated at specified times (say, daily closing price) over some period of time. The most common volatility index, the VIX, measures variation in the prices of options to buy and sell the S&P 500 stocks. In the financial press, volatility and risk are used as if they are the same thing. I think volatility is opportunity. If you think highly of a company, and think it is essentially risk-free (will not fail), volatility—price variation—provides opportunities to buy. Find the range in which it sells (by watching it for six months), and place a buy order near the bottom

When the beginning investor is asked to state his tolerance for risk, it is assumed that the risk of each proposed asset he might buy is known and measured. That is simply false. British Petroleum (BP) of course would survive the Maconda well fiasco. A well blow-up *should* have been anticipated. BP was never a safe operator. Would we have known that? We should have. If we did not know that before, we

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16 If you care to pursue this: Your measure of risk might be the standard error of a regression line in which closing price is the dependent variable; time and perhaps time-squared are the only independent variables.

learned it when the Gulf of Mexico went up in flames. BP's price was uncertain, because of its careless management. But it was not risky.

Consider the "sub-prime mortgage" disaster in late 2007. Lenders created a mortgage for home buyers who could not afford it. By appraising the property ridiculously high, they sometimes allowed purchasers to put no money down, and promise to pay for the next thirty years. The purchasers invested nothing, and later walked away when they could not sell the property or afford the payments.

Mortgage brokers (mostly banks) took a fee for this service. Many such mortgages were then put into a package. That package was sold on Wall Street as a "CDO"—collateralized debt obligation. They were collateralized—backed by some asset—only if you ignored that the asset did not really have the value (could not be sold for the price) ascribed to it. Having sold the package, the mortgage originator no longer was associated with the debt. It made its money on the fee. And the buyer of the package did not know what was inside it, how many mortgages would not be paid. It was a risky investment first because the buyer did not have information about the uncertainty inherent in the asset, and second because that information, if correct, would have carried a substantial probability of failure.

What about the rating agencies—Moody's, Standard and Poors, Fitch and the like? They were chosen and paid by the issuer of the CDO, who wanted as high a rating as it could get. It's like letting the seller's real estate agent select a house inspector. The agent wants to make a sale, and therefore will select the meekest, most compliant inspector. These CDOs were rated "AAA." You were looking for honest product representation from salesmen?

One day Wall Street woke up to the realization that the "value" of these mortgages was less than financial companies had paid for them, although no one knew how much less. To the extent that defaults continued, the value of the bundle declined; but until that happened, the value was still questionable. These bundles had been "marked to model," that is, priced at face value with some standard discount for defaults. Brokerage houses then re-evaluated them by "marking to market." By then, the market feared the worst, so now the values were set too low. You cannot trust the market, and neither can you trust so-called experts. Trust yourself.

## Language

People confuse a thing with a change in it. People may talk about “increasing inflation” when they mean “increasing prices.” An increase in prices *is* inflation. Check that next time you hear an “expert” discuss the economy. For example, when the Consumer Price Index increases by 2 percent, check to see who calls this an increase in inflation. It may be, if the previous increase was, say, 1.5%. Or it may just be an increase in prices.

Similarly we find this sentence in Yahoo’s glossary of finance terms:

Volatility: The risk in the value of options portfolios due to the unpredictable changes in the volatility of the underlying asset.

Options are risky because of possible changes in the *price* of the underlying asset. It is true that, because options expire, the more volatile the price, the more likely you are to find it expiring at a bad time (for example, when the underlying asset has a low price, if the option is to buy, because the option to buy at a fixed price is more valuable the higher the market price). So an increase in volatility might measure increased risk—though I object to their being defined as synonyms—but that means that volatility is measured by change in price, not “changes in volatility.” Besides, one should not use a term in its own definition. That is an elementary editing rule, apparently unknown at Yahoo.

Here is a better explanation of “volatility,” from [Investopedia.com](#):

1. A statistical measure of the dispersion of returns for a given security or market index. Volatility can either be measured by using the standard deviation or variance between returns from that same security or market index. Commonly, the higher the volatility, the riskier the security.
2. A variable in option-pricing formulas showing the extent to which the return of the underlying asset will fluctuate between now and the option’s expiration. Volatility, as expressed as a percentage coefficient within option-pricing formulas, arises from daily trading activities. How volatility is measured will affect the value of the coefficient used.

*In other words, volatility refers to the amount of uncertainty or risk about the size of changes in a security's value. A higher volatility means that a security's value can potentially be spread out over a larger range of values. Meaning that the price of the security can change dramatically over a short time period in either direction. Whereas a lower volatility would mean that*

*a security's value does not fluctuate dramatically, but changes in value at a steady pace over a period of time.*

*One measure of the relative volatility of a particular stock to the market is its beta. A beta approximates the overall volatility of security's returns against the market returns. For example, a beta value of 1.1 means that the security will return 110% compared what the market returns over a specified time period. Conversely, a beta of 0.9 will return 90% of the market's total return.*

They got volatility right (it is a measure of variation), but cannot distinguish risk from uncertainty. Calculated from past history, without correction for trend, however, volatility is not the same thing as uncertainty. And who at Investopedia so massacred “Beta?” That measure has nothing to do with return, and is not always positive. I will discuss it below. These people are experts? These sources represent expert knowledge? I do not think so.<sup>17</sup>

Volatility, variation in price, is only of interest if we are considering buying or selling stocks. The volatility should not affect *whether* you buy it, but *at what price* you buy it.

## Annuity

Just like a bond, an annuity converts an amount of money you have now into a flow of future money. An annuity is a stream of guaranteed future income (the guarantee being only as good as the institution that makes it) in exchange for a fixed sum that you pay now. Many institutions, mostly insurance companies, stand ready to sell you an annuity. Of course they intend to make money on it, which should be some indication to you that it is not a fair bet.

One writer for *Money Magazine* thinks annuities are fundamental to a retirement income:

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17 Ignorance is rife in the financial community. Porter Stansberry defines inflation as an increase in the money supply. No, inflation is an increase in prices. One can hold to the theory that an increase in the money supply generates inflation, but that theory is wrong, as I explain in my Chapter 13, and let's not confuse that theory with a definition.

Similarly, Chris Wood writes in *Casey's Daily Dispatch* of April 30, 2010:

a speculator is someone who allocates capital in order to profit from distortions in the market caused by government intervention.

A speculator may well be trying “to profit from distortions in the market,” such as Nassim Taleb’s theory that rare events are under-valued. Much speculation occurs independent of government action, because someone thinks “the market” has it wrong. Only someone who thinks that, aside from government interference, markets are always and instantaneously perfect, would *define* speculation as Mr. Wood has.

Many retirees should consider an immediate annuity, which kicks off a fixed, regular stream of income for life.<sup>18</sup>

A more sober view, that is, my view, was presented in the same magazine just one month later.

Many annuities have such onerous fees and other drawbacks that you're better off avoiding them altogether.<sup>19</sup>

Ron Lieber presents an appropriately skeptical view of Tony Robbins' annuity discussion.<sup>20</sup> That's right, from lifestyle to money management, Robbins is always on the move, and always self-assured, but not always expert.<sup>21</sup>

If you are going to lose your ability to make judgments, or your physical ability to keep up with the market, follow ideas and act on them, perhaps an annuity is an option. You may have better things to do than read this book and handle your own finances. I still think you would do better with a good dividend-paying stock portfolio. If you insist on an annuity, I'd suggest more than one, with different companies. However, it takes no more than some simple arithmetic to conclude that, in general, annuities are bad bets.

There are many kinds of annuity, including variable annuities that increase the distributions to you over time, but the simplest is a fixed annuity, "a tool designed to produce stable income during retirement."<sup>22</sup> For a given amount of money, you get a fixed monthly check for the rest of your life, no matter how long you live.

### How much?

For example, a 65-year-old man living in New York can pay a \$100,000 premium and thereafter begin receiving monthly payments of \$709 for life, according to [ImmediateAnnuities.com](http://ImmediateAnnuities.com).

At Allstate, a 65-year-old male could currently purchase a \$100,000 single-premium immediate annuity and receive

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18 Penelope Wang, "Seven Secrets To A Richer Retirement," 39 *Money* 9 (October, 2010) at 65.

19 Walter Updegrave, "Ask The Expert," 39 *Money* 10 (November, 2010) at 30.

20 Ron Lieber, "Slippery Tips on Annuities From a Life Coach," *New York Times*, January 17, 2015.

21 Without meaning to pile on, but rather to show that Lieber is not a minority of one, consider this statement from Louis Navellier, whose investment advice I greatly respect:

Tony [Robbins] is a motivational speaker, a life coach and now — apparently — a personal finance guru. Tony's also a neighbor and a friend of mine, so this may get be uninvited from the next Robbins' neighborhood picnic but I've got to be honest... his financial advice stinks.

"The Truth About Index Funds," email June 12, 2016.

22 J. Paul Lim, *U.S. News on line* September 7, 2006

\$622 a month for life. But a 70-year-old who buys the same annuity gets \$712 a month.

At Vanguard, a 70-year-old who buys a \$100,000 immediate annuity can expect around \$9,000 a year for the rest of his life.<sup>23</sup>

There is an unpleasant tax implication worth considering. As explained by Ellen Hoffman:<sup>24</sup>

Suppose you're a 70-year-old man who puts in \$500,000. Based on estimates of your longevity, you're expected to receive \$750,000 over your lifetime. The Internal Revenue Service considers \$250,000 -- or one-third of the total -- as not having been taxed and will require you to pay income tax on one-third of each check you receive.

You might think the net result is that you receive income at one-third your ordinary tax rate. Forever. But if you do not reach the average life expectancy—and half of you won't—then you have paid taxes to get back your own money. No one knows, until you die, how much of your annual return was a return *of* capital, how much was a return *on* capital, but there is no mechanism to adjust, to pay back to your estate the taxes you paid on projected income you never received.

You get the return “forever” as long as both you and the firm that sold you the annuity survive. No one trying to sell you an annuity will point out that two lives are at risk here, but I expect some of these annuities to become worthless as their sponsors fail. To keep it simple, let's ignore that consideration from now on, and also ignore the tax. Think of the monthly payment as a simple interest. In the examples here, annual rates range from 7.5% to 9.0%, except that, by receiving the interest monthly (not waiting until the end of the year) the real return is slightly higher.

This would be a good return on principal, if you get to keep the principal, also. But you do not. When you die, the principal is gone. You can purchase annuities with survivor benefits, but they will pay a lower return. Suppose you are 65 or 70, thinking about purchasing an immediate annuity. You can see the annuity as a \$100,000 pot out of which you get \$8000 a year. Seems like 8 percent, which isn't bad, except that your estate ends up with nothing. Some of the payment is capital being returned to you, so the real return to your \$100,000 is considerably less than 8%. If you could make 8 percent annually on a \$100,000 investment, you would

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23 First quote from an article at Finance.Yahoo.com; latter two from Lim. To make the figures comparable, \$9,000 a year is \$750 a month.

24 *Business Week On Line*, September 7, 2006.

have the same income (paying slightly more tax), and your estate would have \$100,000 more than if you had purchased an annuity with it. The annuity company sees it the same way: If they can make 8% on their money, they will maintain the pot until you die, at which point they own it free and clear. They may make nothing for some years, and then they own your \$100,000. Wouldn't you prefer to leave the principal in your estate?

If you or they can make only 7% on the pot, but take out 8% of your original investment each year, the pot will diminish over time. But it will take 30 years to expire, to reach zero. You are unlikely to live to 95 or 100, so even though you are taking more out of the pot than you put in, after having maintained your income at the annuity level for decades, you would still leave something behind. If you make only 6% on your money, you can sustain the pot (and its \$8000 annual reduction) for 23 years. If you make only 5%, it will last 20 years. That is, investing for yourself is a better bet, even if you cannot make as good a return on your money as the insurance company can. From an annuity, your estate gets nothing—zero. You have given your wealth away to strangers. You can tell that annuities are not good for you by the amount of advertising you see for them. Don't do it. And don't trust any "expert" who suggests that you do.

What if you do not get money back right away? This is called a deferred annuity. You give them a pot of money now, but start drawing a flow from it years later. We are told that no one knows if this is a good deal for an individual or not.<sup>25</sup> You can think that you are the one who will live to 105 and still be collecting income. Most people will die with money still in the pot. You gave your money away, and paid taxes to get some of it back.

Unfortunately, too many people make decisions following the "maximin" rule: Make the worst thing that can possibly happen as unlikely or painless as possible. Maximize the minimum return, even if it stifles your expected return and eliminates any hope of a good return. I see drivers refuse to make a left turn when they can see a car coming, even though it would take 30 seconds or more for that approaching car to reach this intersection, and under 5 seconds to turn. Being behind such drivers is infuriating. I would like better judgment in driving as well as in finance.

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25 This is what Tara Siegel Bernard says in a *New York Times* article, "Buying a Guaranteed Retirement Income, for Some Peace of Mind," June 6, 2014. She is wrong.

## When To Sell

We have purchased dividend paying stocks and sat on them for a while, but now it looks like the deal is going sour. Sell a stock if it is failing to do what it was purchased to do, which in most cases will be providing us with regular and increasing dividends. You did not lose money if the price of a stock you have no intention of selling went down yesterday. If you do decide to sell a truly volatile stock, put in a “good till canceled” order to sell near the top of its trading range. Do not be upset if, after the sale, it then goes higher. You made money by delaying the sale. You attained your goal. You deserve praise.

Risk is the chance that you will lose everything, the number of times in a thousand replays of this decision that you will end up with nothing. Risk is properly contrasted with interest attainable from federal government securities, a sure thing. If the federal government did not pay off its bonds as they come due, the market system would collapse. We must assume that the federal government will pay its obligations, as the Fourteenth Amendment of the U.S. Constitution tells it to, despite the ramblings of truly stupid congress-people. See Chapter 13 of this book.

So we can *define* risk as the chance that you will lose your entire investment. Those who define risk as the chance that you will lose some of it face a more difficult calculation, as the risk must vary by how much you might lose. I call all of that uncertainty. Regardless how we define risk, I know of no good way to *measure* risk, except by one’s lack of information. We now know that one can charge more than \$5 for a cup of coffee. Maybe calling the smallest cup “tall” is a marketing trick but, being investors, we like a marketing trick if it works. What a great stock Starbucks was, and then wasn’t. And then it was again.

Why? Howard Schultz, the former CEO, returned to right the ship. Leadership matters. Starbucks has been an uncertain stock, but risky? Likely to fold? I don’t think it ever was.

Although Starbucks is not going to go out of business, what they do can be done by other companies. I often point to Burger King, Wendy’s, Arby’s, Hardies, Jack-In-The-Box and—what have I left out?—as followers of McDonald’s. Or Quiznos as a Subway follower. Or Papa John’s following in the footsteps of Dominoes. So? Once the idea is out, once customers have been trained to the hamburger or long sandwich or delivered pizza as a “fast food” concept, there is room for more. If you like your local coffee brewer, the company is well run, and you can get a piece of it, by all means do. We have more information now about how people spend money and

time in coffee places (not you, who takes a travel cup filled with the world's second-best coffee, as I explained in Chapter 4). That information reduces risk.

On September 15, 2006, the headline in the Business section of the Portland *Oregonian* read: "Once Feisty Coffee People Whipped Into Starbucks." Coffee People, the otherwise largest coffee chain in Portland, had been gobbled up. "Once feisty" refers to the original Coffee People, prior to 1999, when it was first sold. Now, except for its airport kiosks, Starbucks will retire the Coffee People name. Starbucks saw the world as I just described it: If there is another good coffee company, buy it. Will Stumptown be next?

McDonald's, also, has more information, and, no surprise, now offers a premium coffee. They are doing well with it, even without the lifestyle amenities offered by Starbucks. Except that their stores will be redesigned, because they now know that places designed for children do not attract adults. Dunkin' Donuts is increasing the quality (and price) of its coffee. We can learn by observing. They can, also. It is their job. And we can ask whether selling amenities is a good business model, compared with selling good donuts, made on the premises. Starbucks has brand power, but I think it is in need of some other idea.

What about Starbucks' move to Asia, to tea-drinking societies? I am prepared to believe they will succeed, that coffee, like chocolate, is universally appealing. If you agree, consider investing in a company that pays dividends and wants to sell coffee in Asia. There is more to it than that, but this is a start. Use what you know and what you think. My view is that investing in a company that sells a reproducible product is a good idea if it offers something different from others, or something essential. Propane is the latter; coffee may be both.

## Strategy

The Kaplans describe a the Cornish Man Engine, a nineteenth- century device for getting workers up and down the shafts of tin mines:<sup>26</sup>

It had two ladders: one fixed permanently to the shaft wall, and one that moved up and down with the six-foot stroke of the steam engine at the top. Neither ladder went anywhere, so staying on either one would leave the miner permanently down the pit. But switching to the moving ladder, either at the top or bottom of the stroke, allowed miners to be shunted up or down six feet, before switching again to stand pat by the wall as the stroke returned, and thus make their way to

the seam or the surface in a series of pulls. . . . A miner who switched between them, even randomly, even blindfolded, would spend more time going up than down.

The Kaplans say this is an analogy to Parrando's Paradox, in which randomly switching between two games increases one's chance of winning. Their last sentence is unexplained. The whole concept is unintelligible. It requires very peculiar assumptions to be correct.

First let's assume that the steam engine's power is oblivious to gravity, or the design of this engine makes it so. That appears to be correct. It goes up and down at the same speed. The point is to stay in a fixed position while the ladder is going in the "wrong" direction. Just what switching "randomly" means is not clear, as you always want to go either up or down. Once you have made the first purposeful move (down from the top, up from the bottom), future small "random" moves should leave you where you first got to.

A more advanced Cornish man engine was made in pieces attached to each other on hinges, running continuously, like an escalator, always down one side and up the other. Because both the up side and the down side were regulated by the same motor—in fact, they are the same ladder, joined pieces that go over a drive wheel—the assumption that up and down are at the same speed must be correct.

Add intelligence to the equation. You will only travel in the direction you want. The moving ladder works to get people up or down a mine shaft because they know where they are, where they want to be, and how the ladder can get them there. The ladder itself imparts information, which the sensible rider uses. In Parrando's Paradox the rule is randomness, whereas in the Cornish Man Engine the rule is directionality. To try to make one like the other is absurd. The Kaplans' analogy fails.<sup>27</sup>

Perhaps the Kaplans are thinking of the well-known effect of wind in a foot race. The wind slows you down as much as it speeds you up, but, over the same distance, you will spend more time running against the wind than with it. Your average speed is how fast you go times how long. Therefore wind will slow you down more than it will speed you up, regardless of its direction, if you are running on an

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27 The early Cornish man engine in fact had two platforms and one or two moving ladders. In the latter case, one moved up as the other moved down. Then they both reversed. At the end of travel in one direction, the rider moved to the other ladder, which was about to start moving in the same direction. In the former case, the reason for two stationary platforms was to accommodate people going up (who would step off to one side) and down (who would step off to the other side) without interfering with each other.

oval course. This calculation does not apply to the Cornish Man Engine, as (contrary to the Kaplans' description) the up and down ladders seem to have been joined under any design, much like the counter-weight of an elevator is joined to and moves at the same speed (but opposite direction) of the elevator itself.

I do wish the Kaplans demonstrated more expertise in this book in which they are posing as experts on probability. The point of the Cornish Man Engine is to make *purposeful* changes, the kind you want to make in your portfolio. Randomly switching stocks in your portfolio will get you the market average, minus the costs you incur. Dollar cost averaging works because you buy less the higher the price. It works because it is *not* random.

## Beta

Like “volatility” or “risk,” the beta coefficient of a stock has some important intuitive meaning that is defeated by the way it is usually calculated and used. A “Beta” expresses a relationship between a stock price and the value of some stock index, or, “the market.” If “the market” goes up, is my stock likely to? By how much? That could be a sensible question. After all, we expect “the market” to go up over any long time period. That has been true of the U.S. stock market over any 30-year period in history.

There are two aspects to this relationship: the measure of “the market,” and the measure of a particular stock. Let’s measure the closing price on every trading day. In principle we should measure the price of one stock against all *others* traded on the same exchange, but any individual stock will have a trivial effect on a broad index, one reason why broad indexes are used when calculating Beta.

You will find that most so-called experts do not tell you what measure of “the market” they are using. Here is an example:

Beta: A measure of the price volatility of a given investment compared to the overall market. A beta above 1 is more volatile than the overall market while a beta below 1 is less volatile.<sup>28</sup>

Here is another, similar example:

beta: A measure of the sensitivity of a stock, bond, or fund to swings of an index or the overall market. A beta of more than 1.0 indicates higher volatility than the

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28 In *On Investing*, a Charles Schwab publication for its clients, in the article “Equity Risk: Managing What We Do and Do Not Know” by Greg Forsythe, on page 23. This is referred to as the “definition” of beta.

overall market. A beta of less than 1.0 indicates lower volatility than the overall market.<sup>29</sup>

These are descriptions of how to use a “beta” figure when you have one, but neither is a definition of what it is. Furthermore, this common Beta is un-intuitive, and, strictly speaking, incorrect. The difference should be above or below zero, not above or below one.

Here is one book’s description of such a calculation:<sup>30</sup>

We can estimate a company’s systematic risk by regressing the company’s historical returns on the overall stock market’s returns. The slope of the regression line is called *beta*, and it measures the sensitivity of a stock’s return to the market’s return. The table below shows the results of regressing the returns of our hypothetical company, which we creatively call XYZ Company, on the returns of the Standard and Poor’s 500 Index, which we use as a proxy for the stock market. This table shows that XYZ’s beta equals 1.15

	<i>Coefficient</i>	<i>Standard Error</i>	<i>t-Value</i>
Intercept	-.252	1.014	.25
Slope	1.150	.204	5.62

Residual standard error = 0.0444.  
 Multiple R-square = 0.2015.  
*N* = 60.  
*F*-value = 31.5844 on 1, 58 degrees of freedoms.  
 Durbin-Watson statistic = 2.0801.

What do authors mean by “returns?” Surely they are regressing the price of the individual stock on the average of the S&P 500 index of stock prices, which is the most common “market” measure. Perhaps it does not much matter which index is used. Perhaps the Dow, the New York Stock Exchange Index, the S&P 500 and the Nasdaq 1000 index all move in the same direction. In the long run, they do; but by differing amounts and you might not see such concordance in the short run, which may be where you want to know what your stock’s Beta is. These authors, Brown and Kritzman, do tell us what their standard is, and essentially how the Beta is calculated (by regression). Their description is wrong.

Let’s calculate the coefficients of a regression of the form

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29 From MSN Money (Microsoft–search for “beta” on Bing), October, 2010.

30 Stephen J. Brown and Mark P. Kritzman, *Quantitative Methods for Financial Analysis*, Institute of Chartered Financial Analysts, Dow-Jones Irwin, Second Edition, 1990, at page 53.

$$y = b_0 + b_1 x + \varepsilon$$

where  $\varepsilon$  is error, the difference between the data and your estimate, at any point. We'll set  $x$  as the S&P value at the end of each day, and  $y$  as the daily closing price of a single stock.  $b_1$  is the coefficient in whatever units the index is in, per dollar of this stock's price. A rise of 1 index point implies a rise (or fall if the coefficient is negative) of  $b_1$  dollars of stock price.

This coefficient,  $b_1$ , is *not* a measure of beta. Its units are dollars per share per point on the S&P 500 index. Two equivalent stocks with very different prices (say, Apple before and after its 7:1 split) will have different betas calculated as Brown and Kritzman tell you to do it. To account for average price and average price movement, the beta coefficient should be expressed in terms of standard deviations: A rise of one standard deviation in the index would imply a rise (fall if the coefficient is negative) of Beta standard deviations of your stock price. A high Beta would indeed be a measure of high volatility, but not necessarily of high risk.

A negative Beta implies that as the market goes down, this stock's value rises. There are funds that claim to have exactly this property. Yet so-called experts think it cannot happen. Consider Michael Thomsett:<sup>31</sup>

Beta is the comparison of a stock's price movement tendencies, compared to the market as a whole. It can be applied only when a stock moves in the same direction as the market. If the stock moves in a contrary direction, there is no reaction, and beta is zero.

Wrong. A stock that moves counter to the market has a negative Beta, as any expert would know. Thomsett's Beta is in percentage terms, like Yahoo's; a reasonable definition, but not the same as the previous one, nor as mine. Thomsett's definition would be easy to calculate by regression. My definition has the advantage that the word "Beta" has a precise meaning in social science as the "standardized" regression coefficient: The coefficient of the stock index (regressed against your stock) expressed in standard deviation units.

I have calculated the Betas of two stocks:

Name	Symbol	Beta
Annaly	NLY	-.25
Dominion Resources	D	.84

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31 Michael C. Thomsett, *The Mathematics of Investing*, John Wiley & Sons, 1989.

An increase in the S&P 500 index of one standard deviation will predict a quarter of a standard deviation *decline* in the price of NLY, but .84 of a standard deviation *increase* in the price of Dominion Resources. Annaly, being a high dividend paying stock based on mortgage interest payments, looks better to investors as the “market” goes down; but Dominion, an oil and gas company, looks better when the “market” goes up.

I used data from Yahoo, between February 4, 2002 and May 10, 2010, to make this calculation.<sup>32</sup> A different period of time, as well as a different index, might generate different beta values. It is just an indication of relationships, not a fixed characteristic of the stock.

I cannot say which is the most practical definition of Beta. I simply note that as appealing as the concept is, you have no idea what any so-called expert is talking about when you hear the term on the radio or TV, or see it in print in general, in popular media. Some of the authors quoted here have been careful to tell you what it means to them, but they disagree amongst themselves. Others do not know what it means. Most who cite a figure do not know where it came from, on what index it is based, over what time period.

I find the question uninteresting, ultimately. I choose stocks on the hope that they will increase in value over time, whether “the market” does or not; and more importantly that they generate cash for me to use (if only to reinvest) now. The Beta coefficient is about the price of a stock. It does not incorporate dividends. It says nothing about “returns.” It is not much of a guide to my investing activity.

## Diversification

Jim Cramer plays a viewer-interaction game called “Am I Diversified.” He sees diversification—owning a variety of stocks—as a valuable way to reduce risk, that is, what we call uncertainty. I question this strategy on two grounds. The first is that it asks you to violate the basic rule of investing, which is to purchase the best stock available, where “best” includes its price. The second is that it is based on some classification of stocks—financial, pharmaceutical, manufacture, mining, etc.—which, as I have indicated, not all companies fall into.

Warren Buffett, the billionaire manager of Berkshire-Hathaway, we are told, agrees with me:

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32 Yahoo lets one download historic stock prices. However, there appear to be errors in their data, more severe the further back one goes in time.

If it's your game, diversification doesn't make sense. It's crazy to put money into your 20th choice rather than your 1st choice. It's the 'LeBron James' analogy. If you have LeBron James on your team, don't take him out of the game just to make room for someone else.<sup>33</sup>

However, my rule is really to do what is best for your portfolio which, Cramer might argue, might be to diversify. I still do not agree, because the classification by which "diversification" will be assessed is arbitrary. It is also unrelated to success. Pipeline companies and real estate trusts and fast food chains pay dividends. If you calculate that a certain stock is otherwise the best for you to purchase, next—because it pays a high dividend, seems unlikely to reduce dividends, and has a record of raising them—you might select Enterprise Partners (EPD), W. P. Carey (WPC), or McDonalds (MCD). I see no reason to refuse to select what otherwise is the best stock to add to your portfolio because you already own that "kind" of firm.

Indeed, I do not see any reason to change your opinion if you select a firm you already own. You made a good choice before. Buy more of it. There is no need to diversify by industry or even by company. Buy good companies that pay good dividends and have very little chance of failing. Don't worry whether that increases or decreases your diversification, if it increases your cash flow. Diversification, ultimately, is a formula. Experts do not invest that way.

### **Is it hopeless? Are all so-called experts inexpert?**

My point is, it does not matter. That you do not want someone else to manage your money does not mean no one has anything valuable to say. Those who propose that they have the secret formula are probably charlatans. Even if their formula worked for them, it is not likely to work for the many people they now want to sell it to.

It usually has not worked for them. As Jeff Sommer tells us,

very few professional investors have actually managed to outperform the rising market consistently over those [five] years.<sup>34</sup>

Some people, denigrating proffered "expertise," go too far. Helaine Olen's review of personal finance "experts," though anecdotally revealing, is based on specious

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33 Quoted by Amy Calistri, "Stock of the Month: What Buffett Says About Diversification Will Shock You," April 29, 2012 at [Top Stock Analysts.com](#).

34 Jeff Sommer, "How Many Mutual Funds Routinely Rout The Market? Zero" *New York Times*, March 15, 2015.

reasoning. David Bach, she tells us, suggested giving up expensive retail coffee, making the “latte factor” famous on day-time television appearances.<sup>35</sup> He proclaimed lifetime savings in the millions. Olen presents alternative calculations of lifetime latte savings.<sup>36</sup> One estimate was \$173,000, another, \$165,152. A million dollars, no, but not worth considering as a beneficial life-style change?<sup>37</sup> These are large savings, available to people with little money and expensive habits. This is why I told you how to make the world’s second-best coffee, in Chapter 4. Use it.

Olen notes that most bankruptcies are caused by unexpected (and uninsured) medical expenses, and on this basis scoffs at the Latte Factor. This is a non-sequitur. With or without such expenses, finding areas in one’s life in which to capture savings is worth while. That this strategy alone will not cover six figure medical bills is hardly a criticism.

Someone born into an American family in the bottom 20% of assets, “has a less than 20% chance of making it to the top 40 percent as an adult.”<sup>38</sup> What a wild comparison! Actually, persons born into the bottom quintile are quite likely to end up in the next higher quintile. Personal finance “experts” who promise a route to millions are frauds. That is Olen’s point, and it is correct. But people from low income families who save before they spend, and wisely put their savings to work, can move up the income scale. If they teach these traits to their children, the next generation can move further up.

The conclusion of her book, the final sub-chapter, is “We need to talk about our money.”

If honesty about our personal prospects helps us as individuals, imagine what such a thing could do for us collectively.

If she has specific legislation or popular action in mind, Olen does not say what it is. In the end, she is just another so-called finance expert making money by possessing the title “expert.” Her book may help readers learn to be skeptical, but then what? There are some worthy trees in this forest of rot. Yes, disregard the so-called experts.

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35 See David Bach, *Smart Women Finish Rich*, Broadway Books (1999, 2<sup>nd</sup> Edition 2002)

36 Helaine Olen, *Pound Foolish*, Portfolio/Penguin (2012), latte savings estimates at 53.

37 Although Olen’s descriptions of how successful personal finance authors build empires are telling, her criticism of Stanley and Danko builds from a false premise. They do not propose that a modest life style necessarily leads to millions in assets, only that there are un-ostentatious successful people who perhaps do not and could not own 100 foot yachts, but nonetheless are comfortable in their retirement.

38 Olen *op. cit.*, at 55; indented quote below from page 236.

Do not let them manage your money. Do not pay them for bad advice. But find ways to utilize them to gain some knowledge.

## Following Inside Investors

There is one class of people who have the information we would like to have. They are called “insiders.” The Securities and Exchange Commission (SEC) has its own definition of insiders, those who are subject to insider trading regulation. One of the advantages of SEC regulation is that insiders must report their trading in securities of their own companies. But there are many insiders per company, and many transactions per insider. There is, essentially, too much information. What might we do to derive useful information for our own portfolio?

H. Nejat Seyhoun, a professor at the University of Michigan, has provided a useful book answering some basic questions.<sup>39</sup> Unfortunately, Seyhoun is interested in trades, not investments. His concern is with the stock’s price, not its total return (including dividends). Here, however, is some of the more useful information from that book.

First, Seyhoun recognizes that not all insider sells are based on information about the future of the stock. They may be based on personal needs of the insider. Nor are all buys indications of a glow in the future. Some are the exercise of options. As long as some trades are based on information, however, insiders will do better than outsiders. Knowing what insiders do is useful information to outsiders as long as there is still time, after the information is known (a month after the trades have been made), to act.

Indeed, it does appear, on both buying and selling, that insiders know something, and act on that knowledge. This last action you observed may not be based on such information, but over many transactions made by insiders, some are. The answer to the first question is yes, insiders know something and act legally upon that information.

The second question also has an affirmative answer. As long as you stick to the right kinds of companies (as described by Seyhoun) and the right size of transaction, the gains from the transaction continue long enough into the future (after the insider has made his move) that outsiders can benefit from it.

How do we look through the many transactions for information to guide us? Seyhoun also tells us that we need only look at insider trades of the Chief Executive Officer (CEO). He or she has as much inside information as anyone in the firm, and is as predictive of the firm's future as any other combination of insider actions. So we do not have to run through the SEC's complicated definition of insider, or follow their trades. Just follow the CEO.

Follow how? One can get the information directly from the SEC but, like Seyhoun, I recommend using a service. The most important reason is that you would have to put together SEC reports to make any sense of them. They merely list each trade. Services will summarize them for you, telling you how many shares each officer has purchased in the last month, or six months, or year.<sup>40</sup>

So should we subscribe to an insider trading service and buy stocks the insiders are buying? I do not think so. Here are my reasons.

First, the gain is small. Seyhoun tells us that the gain is in the 2-3 percent range above market trend, disregarding the transactions cost. Many transactions by insiders are not based on special knowledge, and we do not know which ones are. Because "most of outsiders' profits would accrue from some [few] very successful transactions," "outsiders who plan to imitate insider trading must imitate a fair number of transactions to ensure success."<sup>41</sup> "The probability of a loss in a randomly chosen transaction is about 50%." "Outsiders must be ready to mimic approximately 50 insider transactions to reduce the loss probability to low levels."<sup>42</sup> This is the same problem I discussed above with Nassim Taleb's advice. We do not have such deep pockets. If you want to be a trader, read someone else's book. Read Seyhoun's book, which I have seen referenced as indicating that following insider trading is a good strategy. I do not think that is what he is saying.

You can easily beat that 2-3 percent above market by buying only stocks that pay an even higher dividend. Exxon will not share much of its profits with stockholders. Dividends are below 2%. Finding petroleum companies with dividends more than twice as high is easy. That seems to set out a simpler strategy than trading based on insider information. Checking to see what the insiders are doing might tip the balance whether you buy your next proposed stock or not. But it is a

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40 Here are some examples: [www.insiderslab.com](http://www.insiderslab.com), [www.insider-monitor.com](http://www.insider-monitor.com), [www.secform4.com](http://www.secform4.com).

41 Seyhoun, *Investment Intelligence* at 334.

42 Seyhoun, *Investment Intelligence* at 335, followed by 341.

trader's piece of information, sometimes of some short-term value, usually of no value whatever, and you cannot tell which of those times this is.

So-called experts will get on TV and tell you who is doing what with their insider trades. It is fun stuff, information of the interesting but largely useless variety. In the struggle to decrease uncertainty, which means finding real information that will help you project the future of a stock, insider trading is not cost effective. Decreasing uncertainty comes from knowledge about the company. Getting that knowledge from people who have it is so logical that it is, in fact, illegal. Deriving that knowledge from their actions is difficult. You get that information late, and it seldom is the kind of information you want. Understanding and observation of how the world works are more cost-effective strategies for you, the non-expert who just wants to handle his or her own investing.