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THE WALL STREET SELF-DEFENSE MANUAL

A CONSUMER'S GUIDE TO INTELLIGENT INVESTING

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Contents

Introduction

This book won't tell you how to pick stocks. It won't tell you how to get rich quick. It won't tell you how to whip Warren Buffett in your spare time.

What this book will tell you is how to be a smarter investor. It will tell you what matters to intelligent investing and what doesn't (97% of what you hear). It will tell you why you shouldn't *try* to pick stocks, get rich quick or whip Warren Buffett. It will tell you how to evaluate Wall Street products and services. It will tell you how to avoid crippling mistakes. It will tell you how to earn a better return than—if not the Oracle of Omaha—most professional investors, without even sacrificing your *spare* time.

Let me begin, however, by acknowledging an obvious irony: My writing this book. Because, yes, I am *that* Henry Blodget. . .

Well, let's start at the beginning.

I grew up around Wall Street. My first visit to the New York Stock Exchange came at fifteen, a wide-eyed tour through trading booths, storms of paper, and runners darting up and down aisles. My father was a banker, but my mother was the market guru in the family: If my dad had only bought Xerox, she observed, we wouldn't have had money problems. My father, meanwhile, was as concerned about the market's ability to destroy fortunes as to create them. The Wall Street story I heard most often growing up was about how my mother's once-rich grandfather had lost everything while riding the Trans-Siberian Railway during the Great Crash of 1929.*

My Wall Street career began in 1994, in the corporate finance training program at Prudential Securities. My experiences over the next decade, which included the orgiastic peak of an eighteen-year bull market, a brutal crash, and my ignominious departure from the industry, have, by now, been chronicled ad nauseam (although, unfortunately, for legal reasons, not yet by me). Here's a quick summary:

In August 1995, the explosive market debut of a company called Netscape sparked an Internet gold rush. The new industry created a need for new specialists, and, in 1996, after two years in Prudential's technology group, I was plucked away by Oppenheimer & Co. to fill an Internet research chair. Brokerage analysts are ranked against competitors at other firms, and in my first year, I finished dead last. I learned quickly, though, and soon moved up, winning accolades from clients, the *Wall Street Journal, Institutional Investor,* Greenwich Associates and others.

For obvious reasons, bull markets lure millions of people into the stock trading game. Until late 1998, I was only peripherally aware that the stock market had gone mainstream (as I'll describe, analysts mainly serve professional investors, not individuals), but one morning I learned firsthand. I boosted my price target on Amazon, a controversial $240 stock, to $400 a share ($67 in today's split**). This is no different than taking a target on a $24 stock to $40, but the extra

*The reality was more complex, but I carried the image with me: My great-grandfather getting on the train a millionaire and getting off a pauper.

zero hit a media and zeitgeist nerve. The call reverberated around the electronic world, and two weeks later, when Amazon temporarily blasted through $400, I found myself in the odd position of being a financial celebrity.

In early 1999, I moved to Merrill Lynch, where I led the global Internet research team for three years. I was mostly right about the stocks I followed, and I soon became the top-ranked analyst in the industry. For a frantic two years, I was all over the globe—and, thanks to the brief and unfortunate popularity of do-it-yourself stock picking—all over newspapers, radio, and TV. By the spring of 2000, among professional investors, I was the "most read" analyst on Wall Street—and I had become a familiar name on Main Street, as well. Unfortunately, despite believing that the early Internet boom was probably a bubble—and often saying so—I waited too long to pull the plug, and, for much of that year, I was disastrously wrong.

If missing the top had been my only mistake, I would have survived (in part because almost everyone else missed it, too). I also made a more serious mistake, however, which was to write a lot of emotional, unprofessional e-mails, especially during the heat of the crash. Later, amid the wreckage, when the press, public, and regulators began calling for blood, my e-mails did me in. In the 1990s, research analysts had played a significant role in investment banking transactions, and after an investigation of this practice, I was accused by New York State Attorney General Eliot Spitzer of having made remarks in e-mails that were "inconsistent" with my research (popular

**When a company "splits" its stock, it increases the number of shares without changing the total value of the company. As a result, in a 2-for-1 stock split, the price of each share usually gets cut in half. Since December 1998, Amazon has split its stock 2-for-1 and 3-for-1. Thus, my $400 target is the equivalent of $67 in today's shares.

translation: "privately trashing stocks he was publicly recommending"). Along with others, I agreed to pay a humongous fine and be barred from the industry.

To say this was devastating would be an understatement. I loved the business and my colleagues, and, ironically, I had prided myself on handling the conflicts better than many analysts. To not only get benched, therefore, but to have my reputation shattered, was gut-wrenching. Wall Street has an aphorism for disasters in which every constructive option has been explored and there is nothing left to say: "It is what it is." It was what it was, and eventually I realized I had no choice but to figure out what to do despite it.

Which brings us back to this book. One benefit of getting tossed out of your industry is that you get to look at it from the outside. (And I should say here that by "industry," I don't just mean the brokerage business. I mean the whole brokerage industrial complex—brokerage firms, mutual funds, investment advisors, the investment media and the dozens of other businesses that operate in and around the markets.) This perspective helped me see that there is still a vast gulf between how most outsiders think the business works and how it really works—a gulf that frustrates not only outsiders but insiders. It helped me discover that many investment practices I thought were worthwhile, were actually a waste of money and time. And it helped me understand how, in a variety of ways, often with good intentions, Wall Street helps many small investors screw themselves.

The Big Secret (Shhh. . .)

The secret to intelligent investing is not news. It won't fill you with excitement or make you feel like a market wizard. It won't make you rich quick or solve your money problems. It won't relieve you of the need to do what most Americans hate to do (save). It won't impress your friends or make you the toast of cocktail parties. It will, however, make you a lot of money. Here it is:

Diversify your assets, reduce your costs, and *get out of the way*.

That's it. Why? Because the market odds are in your favor. In a casino, if you play long enough, you will lose. In the financial markets, if you play long enough—and don't make mistakes—you should win. Unfortunately, not making mistakes is easier said than done.

For example, if these statements don't ring true, you are probably throwing money away:

- No one knows what the market is going to do.
- The only part of your return you can control is your costs.
- Most investors who seem skillful are just lucky.
- "Long-term" investing means decades, not years.
- Investing in stocks will almost certainly not make you rich.
- Most mutual funds are a rip-off.
- Cash and bonds are risky.
- The biggest risk to your investment return is you.

One problem, much lamented, is that our interests differ from the interests of those who tell us what to do. Despite the squawks of the media, this isn't scandalous; it's just reality: There isn't a business on the planet (including the media business) in which the interests of employees, customers and owners are perfectly aligned. Another problem is that one size does not fit all: Good advice for a hedge fund might be terrible advice for you. A third problem is that, all else being equal, we would rather have fun than be bored, and investing unintelligently can be *really* fun. A fourth problem is that we are genetically programmed to make investing mistakes.

The upshot is that most of us throw away thousands of dollars a year on bad advice, shoddy or overpriced investment products and poor choices—and far more over our lifetimes on subpar returns. If investing were only a diversion—like stamp collecting, say—this wouldn't matter. Thanks to troubled Medicare and Social Security systems and a shift away from traditional pensions, however, intelligent investing has become critical to our future independence and self-esteem.

We invest unintelligently, in part, because we lack a framework with which to evaluate the bombardment of advice emanating from Wall Street, the media, advisors and friends. The first part of this book, A Self-Defense Framework, provides one. The second part of the book, Practicing Self-Defense, applies the framework to financial advisors, mutual funds, hedge funds, investment research, and the investment media, and shows why, despite Wall Street's dangers, *you* will always be the biggest risk to your returns. The third part, A Solution, describes an investment plan that allows you to make mistakes but still generate an above average long-term return.

Investment books usually come in two flavors: the you-too-can-be-Warren-Buffett type, which promises to tell you how to get as rich as Croesus, and the what-they-don't-want-you-to-know type, which portrays Wall Street as a conspiracy of shysters. This book is neither. The average investor will *not* get tremendously rich in the stock market, and Wall Street is actually not out to screw you.

We love to dream, and we never tire of scandal, so these two genres will always be with us. Unfortunately, neither will tell you what you most need to know to make smarter decisions and get Wall Street working for rather than against you. For that, there's *The Wall Street Self-Defense Manual.*

1

How to Get Rich

First things first. I have been advised that if I don't promise to tell you how to get rich in the markets, you won't read this book. So let me get that out of the way.

> How to Get Rich: Invest $100,000 in a *low-cost* equity index fund for fifty years. This should make you about $11 million.*

Yes, it's no get-rich-*quick* scheme, and there is fine print: This performance is not guaranteed. You must reinvest all dividends. You must make the investment in a tax-free account. Inflation will maul you. But no investment strategy is more likely to make you rich than the combination of significant savings, equity returns and time.

I have also been advised to tell you how Wall Street will take you to the cleaners. So let me get that out of the way, too.

> How to Get Taken To the Cleaners: Invest $100,000 in an *average-cost* equity mutual fund for fifty years. This should make you about $6 million . . . and *cost* you about $5 million.**

That's right. Thanks to the magic of compounding, $100,000 invested in a low-cost fund for half a century should grow to $11 million. Thanks to the black magic of advisory

*A "low-cost equity index fund" charges about 0.1%–0.2% of invested assets per year.

**An "average-cost equity mutual fund" charges about 1.5% of invested assets per year.

fees, meanwhile, $100,000 in an average-cost fund should grow to $6 million. That average-cost fund, in other words, will probably cost you $5 million over fifty years.

Wait—where will that $5 million go, again? Will you get swindled? No, assuming you choose your own fund, you will just be making a poor choice. The primary source of a mutual fund's return is the *market*, not the fund, and the average fund subtracts more value than it adds. Every dollar you pay in fund fees, moreover, is a dollar that will no longer compound in your account, and over the long run this lost compounding will cost you far more than the fees (in this example, $4 million vs. $1 million). In other words, you will take yourself to the cleaners—with Wall Street's help.

Here are two more ways to get rich: 1) save more, 2) work in the asset-management business. If you do the latter, you can make a pile of money even if your returns are poor. And here are two more ways to get taken to the cleaners: 1) trade too much, 2) shove your money under a mattress. Frequent trading will likely cost you several percentage points of return per year. After fifty years of average inflation, meanwhile, every dollar you have now will be worth less than a quarter.

Again, the key to investing intelligently is avoiding mistakes and letting the markets do the work. The mistake you make by buying an average-cost mutual fund is that "average-cost" is actually mind-bogglingly expensive. The mistake you make by shoving your money under a mattress is that currency is usually a terrible investment. The mistake you make if you trade frequently is that, in most cases, you would do better if you just bought and held. This last mistake, by the way, doesn't only hurt day traders. It hurts almost all of us. The first step toward avoiding it is to draw a distinction between investing and entertainment.

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The Greatest Show on Earth

What is as challenging as chess and as thrilling as poker? What is played twenty-four hours a day, seven days a week? What is so difficult that only a fraction of professionals do it well but so deceptively simple that even dabblers feel skilled? What offers the celebrity glitz of Hollywood, the dynastic wealth of dictators and kings and the soap opera plots of daytime television? What is legal and encouraged in fifty states but resembles an activity banned in forty-nine? What other than sex, love and death provides grist for so many storytelling mills?

The greatest show on earth, that's what. The financial markets are fascinating, entertaining and fun. In fact, for certain personality types, they are more fascinating, entertaining and fun than most forms of actual "entertainment," many of which are seen as perfectly legitimate ways to spend hard earned money and time.*

What's more, the financial markets can make you money. The odds on Wall Street are (usually) better than the odds in Las Vegas, and even reasonable people can't get enough of

*For other personality types, of course, the financial markets are bewildering, frightening or a colossal bore—all of which create their own risks.

Vegas. You can play the markets without leaving home, from New York or the North Pole. You can play anytime. In the financial markets, there's always something to watch, think and talk about.

But now hear this: If you're serious about investing intelligently, you need to draw a distinction between investing for your future (hereafter: investing) and investing for fun, challenge and entertainment (hereafter: speculating). We will return to this distinction, but for now, let's define "speculating" as any move not made as part of a carefully developed investment plan or any move designed to pay off in less than five years.

There's nothing inherently wrong with speculating: If golf, poker, rock-climbing, and other expensive and/or risky pastimes are okay, then so is speculating. Speculators provide liquidity to markets and fund the development of industries, both of which are positive. But many speculators mistake themselves for investors, so you should be aware of what you are doing. You should know that the long-term return on your speculating will likely be lower than the long-term return on your investing, probably much lower. You should know that the difference between the two returns is entertainment cost and that this cost will likely amount to more than, say, dinner and a movie. You should know, in fact, that this cost could mean the difference between a comfortable retirement and an uncomfortable one.

Easy, you say? You just won't speculate? Well, here's the bad news: Compared to speculating, investing is *boring*. Once you get the basics right, you won't have much to watch, do or talk about. You won't be able to endlessly compare your performance to Warren Buffett's. You won't be able to brag about your brilliant picks. You won't be a font of opinions and prophecies. You won't be able to justify watching CNBC all day, gabbing with your broker, or obsessively checking Yahoo! Finance. In fact, to paraphrase oven designer Ron Popeil, you won't be able to do much more than set it and forget it.

Investing, furthermore—at least investing *well*—will mean ignoring almost everything you see and hear about the markets. It will mean tuning out friends, neighbors, co-workers, gurus and advisors who are alternately panicking or making money hand over fist (and urging you to do the same). It will mean committing to a strategy and sticking with it for *decades*. It will mean saying no to almost everything that seems exciting, challenging and interesting about the markets, including the chance to get rich quick. It will mean playing a different investing game than almost everyone you know, and continuing to play it even when doing so seems stupid, scary and wrong.

Investing intelligently, in other words, will be *hard*. Not because it's technically difficult—it isn't—but because the most powerful force in the markets is human nature, and we're all human. No matter how much you learn, you will always be led astray by boredom, distraction, peer pressure, overconfidence, inertia, envy, fear and greed.

But don't worry. Investing intelligently does not mean that you will have to abandon speculating forever. In fact, there is a simple way to have your cake and eat (a slice of) it, too, and still do better than the majority of investors. I'll describe this strategy in detail at the end of the book. For now, as a first lesson in Wall Street self-defense, just know that most of what passes for "investing" is really just an expensive parlor game, one that costs most players a lot of money, one that you don't have to play.

3

Why Bother?

If investing intelligently isn't going to be fun or make you rich quick, then why do it? In short, because if you don't, you'll be screwed. Traditional pension plans are disappearing, health care costs are skyrocketing, and Social Security payments, if they actually materialize, will barely fund trailer park retirements. By the time you retire, you will need to plug the gap between Social Security, et al, and the kind of life you want to live. How much will you need to do that? More than you think.

Studies suggest that, if you retire at 65, you should spend only 4% of your nest egg per year to be confident it will last the rest of your life (5% if you want to roll the longevity dice). If you retire tomorrow, therefore, every $100,000 of savings would allow you to spend $4,000 per year—assuming you don't have to pay taxes on the withdrawals, as you would with most IRAs, annuities and long-term stock holdings, and, importantly, assuming that you aren't paying steep advisory fees on your nest egg. If you have to pay either taxes or fees, your "safe" withdrawals will be considerably less.

Assume $100,000 of after-tax savings for each $4,000 of spending, and here's your required retirement fund:

Retirement Date: Today
Withdrawal Rate: 4%

Amount Necessary to Fund the Following Spending for 30 Years:

Annual Spending	*Required Nest Egg*
$25,000	$625,000
$50,000	$1,250,000
$75,000	$1,875,000
$100,000	$2,500,000
$125,000	$3,125,000
$150,000	$3,750,000
$175,000	$4,375,000
$200,000	$5,000,000

And that's if you retire tomorrow. If you retire a couple of decades from now, you're going to need a lot more. Why? Because at only a 3% inflation rate—less than the historical average—your money will lose a third of its value in fourteen years, half in twenty-three, and three-quarters in forty-five. If you are a forty-year-old who stuffs your cash under a mattress, by the time you retire, every dollar you have now will likely be worth less than fifty cents. To calculate your required nest egg for a retirement beginning twenty-five years from now, therefore, double the numbers above.

These depressing observations reveal the two primary goals of any intelligent investor. Namely:

1. Avoid *losing* the purchasing power of your savings (harder than it sounds, especially after tax). And, preferably,

2. *Increase* the purchasing power of your savings, after deducting the costs of investment management and advisory services, transactions, taxes and mistakes.

It would be nice if a reasonable investment goal were to "get rich," but, unfortunately, unless you plan on saving a truckload of money, this will take a long, long time. You can, of course, increase your odds of getting rich by taking a lot of risk, but this will also increase your odds of losing everything. It's a free country, and if you can leap from airplanes, smoke cigarettes and bungee jump, you can roll the market dice. But if you do and then regret it, don't waste time trying to find someone else to blame.