

This article was originally published by Guru Focus Media, Inc. in 2006.

The Best Way to Invest, Forever!

By Nicholas Green

Sir William, of Occam, was a renowned fourteenth century British philosopher. He was widely known for the saying "the simpler the explanation, the more likely its correctness." This quote became well known as "Occam's Razor." For those that would like to amass wealth and great riches in the 21st century, Sir William's initial advice would likely be one must earn more than one spends. With the excess cash and savings, Sir William would tell us, one must then invest it to achieve the miracle of compound interest, what Albert Einstein referred to as the 8th wonder of the world.

Once savings are attained, the most logical choice to invest money for compound interest is either in mutual funds or individual stocks or both since stocks, as an asset class, have provided the greatest returns of *any* investment alternative since the turn of the 20th century. If one's goal is to amass wealth versus preserving it, mutual funds are probably not the answer.

The explanation that mutual funds, as a group, are not the optimal choice to amass wealth is no more complicated than an "Occam's Razor." For starters, 6 out of 7 managed mutual funds, or over 85% of them, lag the market, defined by the Standard and Poor's 500. The reasons for this eye staggering disappointment in managed mutual funds for underperformance are too many to list but, here's a few of them just for starters. Most managed mutual funds 1) own way too many stocks that, at best, results in a reversion to the median over time, 2) which will then underperform the market because mutual fund fees are then deducted from the median return, and then finally 3) taxes will put one even further behind a tax efficient index fund.

The arithmetic works like this for your average fund: the average expense ratio is 1.5%, the average trading costs in them are .20%, plus the average tax hit of 2.5% equals a mind numbing handicap of 4.2% annually at the outset to the broad market index.

As noted, there are other reasons the majority of managed mutual funds lose to the market over time but I believe these three – too many stocks, excessive fees, and taxes -- are up there as the largest of the culprits. For those that seek wealth, investors will likely continue to be disappointed with the majority of managed mutual funds.

If managed mutual funds aren't the answer than one might argue that indexes are. While I believe index mutual funds will continue to outperform most managed mutual funds over time one will still be disappointed if ones goal is to amass wealth, especially over the next decade or two. Since 1927, forecasting the market within 1% over any decade has been as rudimentary

as adding the dividend rate, plus earnings growth, plus or minus any changes in the P/E ratio.

Since P/E's are around historical highs we won't likely get any benefit there except for a likely deduction to overall returns. Add the 1.84% dividend yield to the average 5% earnings growth with no change in P/E and we'll be lucky if we get over 6% annual returns on the broad market over the next decade. To make matters worse, Buffett agrees with this assumption, in a recent Forbes article he explained why he thinks the market will return 4-6% over the next decade or longer (note: these assumptions are generally from today's market levels and there is nothing written in stone that the market can't go down).

If Indexes and the majority of managed mutual funds are great for broad diversification and preserving wealth but not the best for amassing wealth then individual stocks must be the answer. As one would guess, the answer is unfortunately not this easy for the majority of individual investors.

From 1984-2000, the longest US based bull market in history, your average individual investor lost to a guaranteed US treasury bond paying 6% by chasing "hot funds" in and out making the argument that most individual investors don't have the right temperament to do it on their own. The Odean and Barber study covering 78,000 individual investors also showed that the majority of investors lagged the market. My experiences in talking to individual investors have only confirmed these studies. Most investors have no investment framework to work from, lack the analytic skills to do a good job, lack the discipline to stay the course, or lack desire and time to put in the hard work.

So what's the road to amass wealth? Aside from the basic truth that one must constantly save *and invest* excess free cash flow over a period of time, I would argue that the roadmap to wealth is the same roadmap that Warren Buffett discovered in the 1950's when he started his career as a "value investor." Before the 1950's, Buffett had saving personal money down to a science but no clue whatsoever of how to go about investing in the stock market (so don't despair if currently you're lacking a roadmap). In 1950 however, Buffett discovered Benjamin Graham and his book *The Intelligent Investor* and *Security Analysis* and Graham and his teachings have since forever shaped Buffett's investment career, path, and philosophy.

When Buffett was reflecting on his career he said, "I chose the best heroes. It all came from Graham." Today, it is no surprise that the majority of the greatest investors of our century and lifetime come from what value investors call Graham and Doddsville. The problem today for the majority of individual investors, advisors, and financial firms is they have taken far different paths than what Graham and Buffett teach. Buffett wrote about a few of the reasons many investors at their own peril and cost chose the wrong heroes in a piece titled *The Superinvestors of Graham- and-*

Doddsville. As Buffett once quipped, financial academics and the like can believe what they want “but I’ve made the most money!” Personally, I side with the money.

To sum up, index mutual funds are likely the best vehicle for preserving wealth over the long term but not amassing it, while the majority of managed mutual funds will fail to beat par (the indexes). The majority of investors will have a disappointing decade or two. To amass wealth, arguably the best course of action is to become an ardent disciple of Graham and Buffett but the better route for the majority of investors is likely to use an investment advisor that has discovered *the best heroes of our time* and have dedicated their lives to the roadmap Graham and Buffett have set down for us.

Unfortunately (or as Buffett might say, fortunately), it is a very difficult task to find such advisors independently or through mutual funds. I’m not suggesting an individual shouldn’t take the time to become of ardent disciple of Graham and Buffett themselves but most people either don’t have the time, the room for error, or inclination for such dedication (if you want to maintain a normal life that is; watch your kids grow up, enjoy leisure activities, have healthy relationships, enjoy retirement, etc).

Of course, my disclaimer is that I am an advisor that believes he is an ardent disciple from the Buffett and Graham camp. Take that for what it’s worth, but I urge you to refer back to an Occam’s Razor: the truth is simply in the pudding or in the history books as they say.