THE 3 GREATEST STOCK MARKET MYTHS EVER TOLD.

Why the financial industry is making billions in commissions and fees by keeping you thinking that you can’t do it on your own.

BY PHIL TOWN
The gold standard of low-risk investing is a ten-year United States Treasury bond, which, right now, has a return of about 4 percent. Invest in nothing but these bonds and you’re guaranteed a 4-percent haul. The only problem with such a strategy, especially for the millions of soon-to-be-retired baby boomers, is that, at 4 percent, it takes 18 years to double your money. In addition, after 18 years, even with a low inflation rate of 2 to 3 percent, most of the gain is absorbed by higher prices, leaving you with only slightly more buying power than you had 18 years earlier. Despite this reality, investors buy billions of dollars of these 4-percent bonds.

Why in the world would anyone want to own a bond that barely keeps pace with inflation and realizes almost no real gain in wealth? Because almost everyone is convinced that a higher rate of return necessarily means a lot more risk. And they’re more afraid of losing money in an attempt to get a higher return than of their inability to retire comfortably.

________________________________________________________________________

THE FACT IS,

A higher rate of return is not necessarily contingent on incurring significantly more risk. Let me explain....
HIGH RETURNS
don’t necessarily mean more risk

During a talk at the America West Arena in Phoenix, Arizona, I asked the audience, “How many of you drove your cars here today?” Most people raised their hands. “Okay, almost everybody. And how many of you took a huge risk driving here?” A few hands went back up. “You guys took a huge risk driving here?” I asked incredulously. “Either you drivers didn’t really take a risk and are just clowning around, or at last we’ve found the problem with Phoenix traffic—you people with your hands up don’t know how to drive. Is that it?” Everybody laughed. “Okay, so it wasn’t so terrifying to drive down here. But now imagine that you’re coming here but instead of you doing the driving, it’s your eleven-year-old nephew behind the wheel. Are you taking a lot of risk now?” People laughed and nodded yes. “The trip was the same—going from A to B. But when you put someone in the driver’s seat who doesn’t know how to drive, a relatively safe trip becomes an incredibly risky trip.”

Exactly the same thing holds true for your journey to financial freedom. If you don’t know what you’re doing, your journey is going to be either very slow or very dangerous. That’s why most people think that going fast (going after a high rate of return) is dangerous—because they don’t know how to drive the financial car, and not...
because going fast is necessarily dangerous. It’s only dangerous if you don’t know what you’re doing. And the essence of Rule #1 is knowing what you’re doing—investing with certainty so you don’t lose money!

Now, you’re probably wondering, “What about mutual funds? What about all those techniques we learn to minimize risk and maximize returns?” Well, folks, I hate to be the bearer of bad news, but here’s the truth: Being a mutual fund investor is a whole lot riskier than being a Rule #1 investor. Investing in a mutual fund is, in many ways, like handing your car keys to that 11-year-old nephew.

**MUTUAL FUND SCAMS & what they don’t want you to know**

If you own mutual funds that are attempting to beat the market, and you’re hoping your fund manager can give you a nice retirement, you’re highly likely to be the victim of a huge scam. You’re not alone—100 million investors are right there with you. Fortune magazine reports that since 1985 only 4 percent of all the fund managers beat the S&P 500 index, and the few who did it did so by only a small margin. In other words, almost no fund managers have done what they’re paid by you to do—beat the market. That significant fact went unnoticed through the roaring 1980s and 1990s as the stock market surged with double-digit growth,
bringing your fund manager along for the joyride. But now the ride is over, and investors are starting to notice that their fund managers are pretty much useless. This is not a new observation.

"Professionals in other fields, like dentists, bring a lot to the layman, but people get nothing for their money from professional money managers.

- Warren Buffett

The key word here is nothing. And yet, what do you do? You give your hard-earned money to one of these guys and hope he can deliver those 15-percent-or-better returns. Why? Because you don’t want to invest your own money, and because you’ve been convinced by the entire financial services industry that you can’t do it yourself.

Come on, get real. From 2000 to 2003, mutual funds lost half their value. You could have lost 50 percent of your money without the help of a professional. In fact, in 1996 a monkey was hired to compete with the best fund managers in New York. He beat them two years in a row. When I told this story one day to an audience in Los Angeles, someone from the upper deck in the Arrowhead Pond Arena yelled out, “What’s the name of the chimp?” This is proof that some people will do anything to avoid investing their own money. In other words, you should be doing this yourself. But you don’t.
But you don’t. The reason you don’t is that the entire financial services industry perpetuates three myths of investing to keep people investing with them in spite of the industry’s dismal performance over any long period.

**MYTH 1**

**You Have to Be an Expert to Manage Money.**

The first myth I want to bust is that it takes a lot of time and expertise to manage your money. It would if investing were hard to learn or if getting the information to make a decision took a lot of time. I’ll prove to you that it doesn’t, even though the financial services industry wants us to believe it does. The industry stands to make billions from commissions and fees if it can keep you thinking you can’t do it on your own.

"The Internet has changed everything."

Now the tools that used to cost $50,000 a year are available for less than two bucks a day and take only minutes a day to use instead of 50 hours a week. All you need is a little instruction and a brief learning period. But don’t bother to ask your broker, financial planner/adviser, certified public accountant (CPA), or fund manager if you should do this on your own. You know what they’re going to say. Something like, “But that’s what I do for you, so you don’t have
don’t have to worry about it.” Well, you should worry about it. A lot. It’s your money and you’re the only one who really cares about what happens to it.

Even the pros like Jim Cramer, a guy who’s in your corner and who wants to see you invest on your own, doesn’t really know what it’s like to be one of us. Like the rest of the top of the financial industry, Jim’s Ivy League, incredibly smart, loves playing with stocks all day and night, lives it and breathes it and has no sense of what it’s like to be you and me out there digging ditches someplace and hoping we can retire. For these guys it’s a game. A serious game, but still a game. Jim’s a trader and loves to speculate. Following his approach, you’ve got to put in five to ten hours a week minimum and you’re playing a very dangerous game with money you can’t afford to lose against really rich, really smart, and really motivated guys—guys just like Jim.

If you think you can win at that game, be my guest. And if you do win, my hat goes off to you. You’re a lot smarter than the rest of us. For everybody else, me included, there has to be another way. Most of us don’t have five hours a week for investing. Let’s face it. We’ve got kids to raise, lives to live, and jobs that already take more time than we have. We also don’t want to be chained to watching the stock market or to become frantic day traders. What fun would that be? We’re just looking for something to invest in that gets really great returns without the risk of losing money and without spending a lot of time at it. Rule #1 is investing for the rest of us.
MYTH 2
You Can’t Beat the Market.

Okay, it’s true that 96 percent of all mutual fund managers have not been able to beat the market in the last 20 years. But you’re not a fund manager and you’re not judged by whether you beat the market. Your financial skill is judged by whether you’re living comfortably when you’re 75. You shouldn’t care whether you beat the market. If the market goes down 50 percent but your fund manager loses only 40 percent of your money, he may have beaten the market, but does that seem good to you?

“Rule #1 investors expect a minimum annual compounded rate of return of 15 percent a year or more. If we can get that, we don’t care what the market did. We’re going to retire rich anyway. Judged by that standard, Rule #1 investors . . . well, rule.

The myth that you can’t beat the market was started in the 1970s by, among others, Professor Burton Malkiel of Princeton University, who did lots of research purporting to prove that nobody beats the market. His book, A Random Walk Down Wall Street, still sells. He influenced a generation of professors in business schools who, as a body, subscribed to what has become known
as Efficient Market Theory (EMT). EMT says markets in general (and the stock market in particular) are efficient—that is, they price things according to their value. In the stock market, the ups and downs of the market are caused by rational investors responding minute by minute to the events that may affect their investments. According to EMT, the market is so efficient that everything that can be known about a company is already, minute by minute, figured into the price of its stock. In other words, the price of the stock at all times equals the value of the company.

If that’s true, say the professors who believe in EMT, then it’s simply not possible to find a stock that’s undervalued, and it’s equally impossible to pay too much for a stock. Why? Because price is always equal to value. So there are no deals in the market, and there are no rip-offs. This situation, EMT theorists say, accounts for the fact that almost no fund managers ever beat the market. These fund managers are smart guys, and if none of them beats the market for long periods, then the market must be perfectly pricing everything.

But some people do beat the market for long periods, and the point of Rule #1 is to show you how. You’ll soon realize how false EMT really is.

In 1984, Warren Buffett gave a lecture at Columbia Business School in which he showed that at least 20 investors, who he’d predicted would have high rates of return, all beat the target of 15 percent handsomely for periods longer than 20 years. All of these
investors hailed from the same school of investing, which he called “Graham-and-Doddsville” because all had either learned from professors Graham and Dodd, from Buffett, or from someone who was copying Buffett—the same way I learned from my teacher and the way you’re learning from me. (Benjamin Graham was Buffett’s teacher at Columbia; David Dodd was another professor at the school.) The compounded annual rate of return for these investors over eight decades ranged from 18 percent to 33 percent per year. The point Buffett was making to the Columbia students was that the people he knows who make over 15 percent a year for long periods all do it similarly. They all start with Rule #1.

After the 2000 to 2003 stock market debacle, when some very good businesses saw their stock values drop by 90 percent, Professor Malkiel was interviewed, and came as close to a retraction of his theory as an academician ever could when he admitted that “the market is generally efficient . . . but does go crazy from time to time.” Oh.

It’s efficient but sometimes it’s not. Funny, but I thought that was what Buffett and Graham had been saying for 80 years. Buffett quips that he hopes the business schools will continue to turn out fund managers who believe in EMT so that he’ll continue to have lots of misinformed fund managers to buy businesses from when they price them too cheap, and to sell businesses to when they’re willing to pay too much.
The chart shows how Rule #1 investors have fared over the last several decades, as compared with the performance of the S&P 500 and the Dow Jones Industrial Average.

How Rule #1 investors have fared in comparison with the market’s most popular indexes. This chart may appear erroneous or exaggerated, but it’s not. Rule #1 investors outperform the S&P 500 and the Dow Jones Industrial Average by a long shot—routinely. The magic of compound growth is what explains the massive difference between compounding at 8 or 9 percent per year versus compounding a little over 23 percent per year.

Such a huge difference isn’t so obvious at first glance. Because 23 percent is just three times bigger than 8 percent, one would automatically think the dollars should just be three times bigger.
But compounding growth is not linear, it’s what is called geometric. Compounding grows a rate of return not only on the original dollar invested, but also on the accumulating dollar returns (“interest on interest”). Because 23 percent produces a higher dollar return every year, which, in turn, has a 23 percent return on it, the accelerating dollar amount explodes after several years and rockets far from the lower 8-percent compounded return.

**MYTH 3**  
To Minimize Risk, Diversify and Hold.

Diversify and hold. Everybody knows that’s the safest way to invest in the stock market, right? But then again, at one time everybody knew the earth was flat. The fact is, a long-term diversified portfolio would have had a zero rate of return for 37 years from 1905 to 1942, for 18 years from 1965 to 1983, and from 2000 to 2005. Sixty years out of 100. If you know how to invest, meaning you understand Rule #1 and know how to find a wonderful company at an attractive price, then you do not diversify your money into 50 stocks or an index mutual fund. You focus on a few businesses that you understand. You buy when the big guys, the fund managers who control the market, are fearful, and you sell when they’re greedy.
Today, more than 80 percent of the money in the market is invested by fund managers (pension funds, banking funds, insurance funds, and mutual funds). This what is known as “institutional money.” Out of $17 trillion, the big guys manage more than $14 trillion of it. In other words, the fund managers are the market; when they move billions of dollars into a stock, the price of that stock goes up. When they take their money out, the price of that stock goes down. Their effect on the market is so huge that if they decide to sell suddenly, they can generate a massive crash. Understanding this fact is central to Rule #1: The fund managers control the price of almost all the stocks in the market, but they can’t easily get out when they want to. You and I, however, can be in or out of the market within seconds.

So what happens in the long run if the baby-boom money that drove the market up starts to come out as the baby boomers retire? Or what if some other event draws money out of the market? As mutual funds drop in value, investors react by withdrawing money faster from the funds, which ultimately puts the market into free fall. The irony is that while, in theory, investing for the long run in a diversified mutual fund lowers risk, such an investment strategy in this market actually raises risk. In this market there’s no such thing as a “balanced portfolio” that reduces your exposure to market risk, no matter how loudly the financial services industry salesmen shout it. If this market crashes, fund managers who play these games may find themselves rearranging deck chairs on the Titanic.
If you don’t think a total stock market meltdown can happen in a modern economy, think again. It just happened over the last ten years in Japan, whose stock market lost 85 percent of its value from 1992 to 2002. It hasn’t recovered yet. And Japan’s boomers are about ten years older than America’s (political and economic factors prompted a baby boom in Japan prior to the start of World War II). If America’s market tanks 85 percent, the Dow will be at 1500. It happened during the 1930s. It can happen again.

Diversification spreads you out too thin and guarantees a market rate of return—meaning whatever happens to the whole market happens to you. Obviously there are hundreds of great businesses available to buy, but if you have a job and a family and don’t want to be married to your computer, you don’t have time to keep up with more than a few. If you buy businesses you don’t keep up with, you’ll inevitably violate Rule #1 with respect to some, causing your overall return to drop.

As Rule #1 business buyers, we pick a few choice businesses in different sectors of the market. So even though we aren’t “diversifying” like mutual fund managers by buying dozens—if not hundreds—of different companies at once, we’ll be setting up a portfolio that reflects different categories of businesses. But exactly how many companies you can buy into will depend on how much money you have to invest, and I’ll tell you what the right proportional relationship is.
“Diversification is for people who have 30 years to go, have no desire whatsoever to learn how to invest, and are going to be happy with an 8% yearly return and a minimum standard of living in retirement. Our goal is to find wonderful companies, buy them at really attractive prices, and then let the market do its thing—which means eventually the market will price these businesses correctly at their value; in a few weeks, months, or years we’re a lot richer than we are right now. That’s what we want to do. But to do that, we have to stop being ignorant investors being taken advantage of by the entire financial services industry and start being knowledgeable Rule #1 investors who, instead of being the prey, outfox the predators.

In the mid-1960s my dad suggested I put money in a diversified mutual fund. I invested $600 and forgot about it. Eighteen years later my investment was worth $400. Imagine if I were 45 years old in the mid-1960s and I invested $60,000 instead of $600. How depressing would it have felt 18 years later at age 63 to discover my $60,000 had become $40,000 instead of the $240,000 I was planning on for my retirement?
The first reason you should bother to learn The Rule is that you can make 15 percent a year or more with very little risk, and that’ll change the way you and your family live forever. You can’t do that in real estate, in a mutual fund, or by randomly picking stocks out of a hat. The second reason is that when you invest by The Rule, it almost doesn’t matter what amount of money you start with; in 20 years you can retire comfortably.

### THE 3 MYTHS VS. Rule #1

<table>
<thead>
<tr>
<th>MYTH</th>
<th>RULE #1</th>
</tr>
</thead>
<tbody>
<tr>
<td>It’s hard &amp; takes a long time</td>
<td>It’s simple, taking at most only 15 minutes a week</td>
</tr>
<tr>
<td>You can’t beat the market</td>
<td>You can take advantage of regular mispricing to reap a 15% return or more</td>
</tr>
<tr>
<td>Diversify, buy, and hold</td>
<td>Buy a dollar for 50 cents, and sell it later for a dollar. Repeat until very rich</td>
</tr>
</tbody>
</table>

### WHY BOTHER LEARNING RULE #1?

The first reason you should bother to learn The Rule is that you can make 15 percent a year or more with very little risk, and that’ll change the way you and your family live forever. You can’t do that in real estate, in a mutual fund, or by randomly picking stocks out of a hat. The second reason is that when you invest by The Rule, it almost doesn’t matter what amount of money you start with; in 20 years you can retire comfortably.

<table>
<thead>
<tr>
<th>STARTING AMOUNT</th>
<th>MONTHLY SAVINGS</th>
<th>IN 20 YEARS</th>
<th>ANNUAL IN 20 YEARS</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1,000</td>
<td>$300</td>
<td>$470,000</td>
<td>$70,000</td>
</tr>
<tr>
<td>$10,000</td>
<td>$300</td>
<td>$650,000</td>
<td>$97,000</td>
</tr>
<tr>
<td>$50,000</td>
<td>$300</td>
<td>$1,450,000</td>
<td>$215,000</td>
</tr>
</tbody>
</table>
If you could retire with a permanent income of $70,000 a year 20 years from now, starting today with just $1,000, would you want to learn to do that? It’s possible, as we’ve seen, if you accumulate money for 20 years and from then on consume only the gains, leaving the principle untouched. So if you start with $1,000 your principle is almost $500,000 in 20 years, and if you continue to make 15 percent a year, you have $70,000 a year to live on—without ever touching that half a million. If you start today with $50,000, your principle in 20 years will be $1.45 million, allowing you to live off a $215,000 (15 percent) gain each year. Think you can handle that kind of retirement? The key is to bank 15 percent or more returns a year from all that you’ve amassed over those initial 20 years (and beyond), which will get even higher returns. And if you don’t think you have 20 working years left before your targeted retirement date, you can still generate a decent amount of money following The Rule, and make that money continue to work for you in retirement.

WANT TO LEARN HOW to Copy the Best Investors in the World?

Register for my monthly webinar where I’ll show you how you can make huge returns and take less risk than your taking in your mutual fund.