Here’s Larry Siegel dusting off his “nine myths of investing.”

- We will be in a low-growth environment for the foreseeable future.
- The endowment model is broken.
- Diversification doesn’t work any more.
- Alternatives are where the return is, so these managers deserve their high fees.
- You should try to minimize fees.
- Active management only makes sense in markets that are inefficient.
- It is a good thing to be an absolute return investor.
- Liability-relative investing is good in theory, but interest rates are too low.
- All you need is alpha. Alpha makes the difference between a successful and a failed investment program.

Read on for Larry’s take. . . .
On April 29, 2010, I spoke on “nine myths of investing” at the Terrapinn Brasil Investment Summit in São Paulo, Brazil. Popular myths do not die quickly but they gradually change — as do markets, which have doubled in the meantime — so here is an update.¹

**MYTH #1: “ALL YOU NEED IS ALPHA. ALPHA MAKES THE DIFFERENCE BETWEEN A SUCCESSFUL AND A FAILED INVESTMENT PROGRAM.”**

Elroy Dimson, Paul Marsh, and Mike Staunton, the British finance gurus who collect centuries’ worth of data in dozens of countries, point out that you only need to save 10% of salary to retire comfortably if the real return on your retirement or pension program (DC or DB) is 4%. However, you need to save 16% to 20% of salary if your real return is 1% or 2%.²

This is correct assuming 40 years of compounding and a modest definition of “comfortable,” so why don’t we all just try to earn “real 4%”? The answer is that we are already trying, using beta (asset-class returns). Most pension and retirement portfolios are pretty well diversified. Target-date funds have gone a long way toward making this true on the DC side. You can’t get much more bang out of moving toward the efficient frontier if you’re already almost on it.

And most of the bang in these funds comes from equities, which have had an expected real return around 4% for most of this young century. If the actual return had been close to the expected return then we would be well on our way to comfortable retirements or whatever one’s particular investment goal is. But actual returns have been much worse — the MSCI World equity index is up only 0.71% per year in real terms since the end of 1999, and the S&P hasn’t done much better at 1.87%.³

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¹ The original was written up in *All About Alpha* at [http://www.allaboutalpha.com/blog/2010/05/02/ordem-e-progresso/](http://www.allaboutalpha.com/blog/2010/05/02/ordem-e-progresso/).


³ Data from January 1, 2000 to December 31, 2015. While the MSCI All-Country World index is the best reference point for a generic equity portfolio, that index isn’t available before 2001.
Future beta returns may be better but, given the starting level of market valuations, we’d be surprised if they were dramatically better in the near term. So, is alpha the answer? Can making “alpha bets,” attempts to beat the market, solve the problem that arises from earning 1% or 2% in beta return when the situation demands 4% (all in real terms)?

Let’s start with the zero-sum principle that alpha bets can only work for a given investor if they work the wrong way for somebody else. That is, all alpha is earned at the expense of other investors, who must be willing to continue to participate in markets while earning a negative alpha. So, in aggregate, we have to take what the markets give us.

If the (realized) real return on your portfolio is 1%, you need a 3% annual alpha to bring it up to 4%. This is achievable by some investors in any given year but is not achievable over the long periods of time that really count. In 2000, two friends of mine at Barclays Global Investors, and I, collected returns on all the funds for which we could find 20 years of data — equity and fixed income mutual funds, institutional accounts, pension funds, endowments, hedge funds, and so forth. Of the 494 funds we studied, only six funds had a 20-year alpha above 4% per year, and 43 funds had a 20-year alpha above 2%.4

While that’s not a terrible track record, there’s obviously not enough alpha to go around if a large number of investors want to claw their way up to “real 4%” from some much lower asset-class or beta return. And note that our sample is survival-biased; only the funds that investors thought were good enough to keep alive for 20 years are included. Finally, while the data are old, there is no reason to think that the environment for earning alpha has improved; it’s probably gotten worse.

That doesn’t mean you shouldn’t try to beat the market. A few managers will earn really exceptional returns. But it’s a neat trick if you can identify these managers in advance, get enough money allocated to them to make a difference, and not have them counterbalanced by underperforming assets. Few investors can do that; I cannot think of a harder job than successful selection of successful active managers. The markets make monkeys out of most of us in the long run.

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4 This study is on my website, [http://www.larrysiegel.org](http://www.larrysiegel.org), at [https://larrysiegeldotorg.files.wordpress.com/2014/07/barclays-greatest-ii.pdf](https://larrysiegeldotorg.files.wordpress.com/2014/07/barclays-greatest-ii.pdf).
What to do? As Jack Bogle has said, budget for it. You’ll need more savings to generate the same amount of income. If you don’t save more, you’ll have less income. This is as true on the DB side, where savings are called pension contributions, as on the DC side.

MYTH #2: “LIABILITY-RELATIVE INVESTING IS GOOD IN THEORY, BUT INTEREST RATES ARE TOO LOW.”

Buying a portfolio of assets that, in aggregate, has the same beta exposures as the liability is the lowest-risk position at any level of interest rates. It always was and always will be, no matter what the specific liability is and no matter what the level of interest rates is. It’s just Finance 101. By “betas” I mean any systematic risk factor that can be bought or hedged in the markets, not just equity beta. Duration is a type of beta and is the beta exposure that matters most for asset-liability matching.

Every pool of assets was established to pay a liability. These pools of assets include defined-benefit pensions, endowments, foundations, individual savings and DC plans, sovereign wealth funds, and everywhere else that money is gathered. The legal or accounting liability may be less clearly defined for some of these pools than for others, but the economic liability is whatever the spending or payout is expected to be, discounted to the present at the riskless Treasury yield curve.

Why is this the riskless position? If the liability is fully funded and duration-matched to the assets, there is nothing that can happen, short of a complete meltdown of the payments system that can cause the liability not to be paid.

What is the risk of not being asset-liability matched? Interest rates could go down even further; stranger things have happened, including negative rates in Europe and Japan. You, or your investors or clients, would then be much worse off.

Interest rates are more likely to go up. However, if you’re duration matched, the market values of the assets and liabilities will decline at the same rate. Again, there is not much risk; duration matching is the risk-minimizing strategy. There is an opportunity cost in that you might have been able to reduce shortfalls or increase the surplus through interest rate timing, but how has interest rate anticipation worked out for you in the past? Didn’t you think interest rates would rise when they fell through 4%, then 3%, then 2%?
Any attempt to add return beyond the liability-matching asset mix is all well and good. But such an attempt could backfire, producing a larger shortfall or a smaller surplus. Bets on risky markets, when there is a riskless alternative that you could have held, should be regarded as alpha bets. Any positive results from them, even if achieved through an equity index fund, should be scored as alpha relative to the proper benchmark, which is the liability, and any negative results should be scored as negative alpha.

**MYTH #3: “IT IS A GOOD THING TO BE AN ABSOLUTE RETURN INVESTOR.”**

Except for a very few completely market-neutral hedge funds, there is no such thing as an absolute return investor. Almost all portfolios are exposed to market fluctuations.

“Absolute return” is a flag that is hung by many fund managers and marketers over just about anything that does not look like an index fund or else an active fund built by taking deviations from a benchmark. Supposedly absolute-return funds can include private equity, venture capital, commodities, real estate, infrastructure funds, and hedge funds that are not completely hedged.

This is “absolute” baloney. An example of an absolute return is 10%. Show me a fund that returns 10% every year, or, let’s say, 8% over inflation or over the riskless rate every year, and I’ll show you the next Bernie Madoff. It isn’t possible to earn an absolute return in risky markets any more than it’s possible to bat “1000” (100%) in a baseball season. It may be mathematically possible but no one will ever do it.

There are a few quantitative hedge funds that hedge their market exposure dynamically so that they always have an expected beta of zero. They are still not absolute return investors in a strict sense because the realized beta will differ from the expected beta, sometimes by significant amounts. But at least they’re trying to engineer a zero beta to all relevant factors, so I’ll excuse them calling their funds absolute return. Otherwise, no.

**MYTH #4: “ACTIVE MANAGEMENT ONLY MAKES SENSE IN MARKETS THAT ARE INEFFECTIVE.”**

Well, of course. Active management is self-evidently a waste of time and money in markets that are perfectly efficient.

But all markets are inefficient to some degree, even the U.S. Treasury bond market. The great investor Jack Meyer, who used to run the Harvard endowment, made a
small fortune for his employer by betting that an unusual kink in the Treasury curve would straighten out. It did. There are always opportunities to make money through active management in any market. As long as you also remember that active management is a zero-sum game in all markets, no matter how efficient or inefficient, you’ll be thinking about the active-passive decision correctly.

I earlier referred to a Barclays Global Investors study that I helped with, in which we looked back at 20-year track records from all kinds of funds, and tried to figure out what the best performers had in common.

The answer was that they had almost nothing in common, but the fun part was just figuring out who the greatest managers were. It turned out that the highest alpha produced over 1980-2000 was that earned by Berkshire Hathaway. This may not be a big surprise, but it was achieved in U.S. large cap! That might be a surprise. So much for active management only making sense in the most inefficient markets.

**MYTH #5: “YOU SHOULD TRY TO MINIMIZE FEES.”**

No, you should not try to minimize fees. You should try to maximize expected return after fees.

Several wise (and wealthy) commentators have suggested that the best way to increase return is to decrease investment costs, which include fees. This is correct if you have no skill at picking active managers. You should just index, which is the lowest-fee approach. But a pure index strategy misses out on some of the most interesting economic opportunities in the world. Active management is not useless.

If you meet the Two Conditions for selecting active managers, maximizing alpha after fees involves paying (some) active fees. I alluded briefly to the Two Conditions earlier when I said that successful selection of successful active managers is hard. Barton Waring, with three co-authors at BGI, formalized the Two Conditions as follows: (1) you have to believe that skillful active managers exist, in other words, that their good track records are due to more than random chance, and (2) you have to have your own skill at picking them, because there are many more unskillful managers than skillful ones.5

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Investors who meet these conditions should blend index funds and active management, focusing their active management efforts in areas of the market where they believe skill is most likely to exist and where they think they can identify skillful managers. The fees they pay will also be a blend of index and active, with expected fees deducted from the expected before-fee return. This calculation can be done in a “manager structure” optimizer, like the one described in the article by Waring et al., or it can be done informally.

Investors who do not fulfill the Two Conditions should just index.

**MYTH #6: “ALTERNATIVES ARE WHERE THE RETURN IS, SO THESE MANAGERS DESERVE THEIR HIGH FEES.”**

Some managers do deserve their high fees. Let’s say you have a secret formula for beating the market, but no capital. Such opportunities sometimes do exist, and can be exploited profitably for quite a while before they are arbitraged away; the simplest example is small-cap stocks in John Neff’s heyday, from about 1974 to 1983.

To exploit your secret formula, you go to the bank, but they won’t give you a loan; they don’t understand your business model. So you go to the capital markets, and you are offered this deal: you have to give 80% of the profits to the capital provider but, before distributing the profits in that way, you are allowed to keep 1% or 2% annually to cover fund expenses so you do not go broke while waiting for your genius at beating the market to be revealed.

Highway robbery! Who would give up 80% of the profits from a business venture to get funding? Who would need to? But that is exactly what the 2-and-20 hedge fund fee structure does.

The problem with this story is that it assumes you are an actual genius and can beat the market — or some relevant market-related benchmark — by enough to cover these various fees and expenses, and then some (so that there is profit left over for the capital provider). Repeat the story 11,000 times, since there are that many hedge funds, and it is almost certain you’ll run out of geniuses. Or, looked at from the supply side, there simply cannot be that many arbitrage opportunities, market inefficiencies, and special situations.
Maybe in 1968, there were 200 geniuses running the roughly 200 hedge funds that existed at the time, but it’s hard to imagine that geniuses have proliferated so wildly that there are now 11,000 of them.

Most alternative asset managers — I am picking on hedge funds but that is just an illustrative example — earn market returns, plus or minus an error term, minus their generous fees. The aggregate alpha available in the market was zero in 1968. It still is.

Moreover, high fees attract mediocre as well as superior managers. All managers, no matter how skilled or unskilled they are at alpha production, are skilled at putting their best foot forward and looking smart. And I’d be the first to admit that, for certain strategies such as private equity, there’s an “assembly charge” that you just have to pay to get access to the asset class; the investor can’t replicate the kind of work these people do. But, in general, when evaluating alternative investments — just as with traditional investments — the burden is on the end-user investor to find superior managers from a population that is close to average and that earns the return on the benchmark before fees; less than that after fees.6

**MYTH #7: “DIVERSIFICATION DOESN’T WORK ANY MORE”**

I heard this a lot after the crash of 2008. The claim is too silly to take seriously, but some people believe it so let’s address it.

The original alternative asset, Treasury bonds, provided excellent returns during the crash. So did cash.

Nobody ever said that diversifying among 50 kinds of equities would reduce risk very much. And international equity, emerging market equity, frontier market equity, private equity, private investment in public equity, public investment in private equity, equity hedge funds, and even credit (risky bonds) are all types of equity!

OK, I’ll stop.

**MYTH #8: “THE ENDOWMENT MODEL IS BROKEN”**

If the endowment model is that “anything worth doing is worth overdoing,” then it’s broken. But that is not the essence of the endowment model.

6 The author thanks Barton Waring for originally articulating the argument in this section.
The endowment model properly understood is this:

*Think broadly about diversification.* There is probably more than one risk factor that is rewarded. Take all asset classes — not just public, liquid asset classes — as your opportunity set.

*Be a truly long-term investor.* The long term is not 3, 5, or 10 years, but the amount of time from when an investor saves a dollar, or contributes it if you are talking about a pension fund, until she needs it back for consumption. That could be 20 or 30 years or more, conceivably much more. Some of the dollars in the fund could stay in the fund for a year, and some could stay in the fund for 75 years, with the dollar saved when the investor is 25 years old and spent when she is 100.

So it is appropriate to invest some proportion of one’s portfolio in investments where you won’t know whether they’re “working” for a long time, longer than the tenure of any chief investment officer or fund trustee.

The problem with that kind of investing is that, without some guideposts to help you figure out in the short run whether the strategy is “working,” there is no way to know whether it will work in the long run. So investments that have a very long time horizon and that provide little or no information along the way, such as infrastructure investments, should have a limited role in the portfolio — but they should not be excluded from it.

Finally, *be willing to sacrifice liquidity for higher returns,* if there is a liquidity premium in the asset under consideration, and only up to the point where liquidity sacrifice doesn’t threaten the financial soundness of the institution.

I have written negatively about illiquidity in the past. My 2008 article in the *Journal of Portfolio Management,* “Alternatives and Liquidity,” was an argument that having too much in illiquid alternatives would cause portfolio managers to have to sell liquid securities in bear markets to raise cash for spending, fund redemptions, and capital calls, with the result that their allocation to illiquid assets would go up and up, possibly hitting 100% and, if additional redemptions are required, with the fund becoming insolvent. This is one of the few correct forecasts I’ve ever made.

But the current environment may have taken matters too far in the other direction. The S&P 500 has gone almost straight up for seven years. Most investors don’t seem to want any other assets and have begun to treat the S&P 500 as the riskless or
reference asset in much the same way as they did in the late 1990s. This is a mistake. Equity markets go down as well as up, and investments with long lockups sometimes go up as well as down. An example — by no means the only example or the best example — is natural resource-related private investments in emerging markets, which can take the shape of either private equity or private debt. After years of terrible performance, nobody wants them, which is exactly why a long-term investor following the endowment model might.

**MYTH #9: **“**WE WILL BE IN A LOW-GROWTH ENVIRONMENT FOR THE FORESEEABLE FUTURE.”**

I don’t know how much of the future is foreseeable — maybe none of it — but the future that is relevant to investors is, as I said earlier, the amount of time starting when a dollar is saved and ending when it is consumed. So, for any given individual, the future with which she should be concerned is the next 20 to 80 years, depending on her age and life expectancy. Over such a long period, we don’t need to be too concerned with current market valuations and should only look at macroeconomic trends.

Much has been said about the slowing of growth in the 21st century, especially when compared to what the Northwestern University economist Robert Gordon called the “special century” of 1870-1970. Using that lofty benchmark — when essentially all of the tools of modern life were either invented or put into widespread use — almost any other century, past or future, might be a disappointment. But, given that we are at a starting point where the per capita GDP of the world is a solidly middle-income $14,957 — about what U.S. per capita GDP was in 1947-1949, with both numbers converted to today’s money — even a slowed pace of further growth is a blessing. But there isn’t much evidence that growth is slowing.7

This claim may sound strange, but only because we in the United States tend to see things from a domestic perspective. The U.S. growth rate has been slower since the crash of 2008 than before. But U.S. investors do not invest in the U.S. economy — they invest globally. (Even the S&P 500 has a large non-U.S. profits component, and savvy investors use a global benchmark like the MSCI All-Country World Index, not the S&P 500.)

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7 World GDP is from the World Bank (2014 data; the current number is a little higher) and is converted to U.S dollars using purchasing power parity.
And, worldwide, the real GDP growth rate is about 3.5%, almost exactly what it was before the crash. Growth leadership has pivoted from developed to developing markets, which is good if you live in one of the developing markets (they desperately need it). U.S. workers may feel left out, but U.S.-based investors can earn the same returns as investors anywhere else in the world, by holding global portfolios. There is nothing about slowing growth rates and aging populations in developed countries that should alarm long-term investors — and, as I’ve argued elsewhere, one can hardly imagine any better news than that the global population explosion is almost over. That’s the reason for the aging populations.8

In the very long run that I’ve argued we should be concerned with, equity markets are driven by macroeconomic growth, which in turn is driven by changes in technology. The technological innovations that are currently on the horizon are stunning, and include (from my recent review of Gordon’s book The Rise and Fall of American Growth):9

- Cheap energy from nuclear, solar, wind, geothermal, and other sources;
- Cheap shipping, enabling the world’s poorest people to compete in global markets
- Robots and drones, eliminating most of the boring and soul-killing work that people now do;
- Geographic information and mechanical control systems good enough to enable self-driving cars to beat humans at safety tests right now;
- 3-D printing of replacement parts for human beings, now being done in dentistry; and
- Innovations in bioengineering and genetic engineering that will eventually make most physical and mental illnesses much rarer.

Yet the biggest advances in human well-being, and thus indirectly in investor prosperity, may come from technology diffusion. An example is the flush toilet, which is more than 400 years old by the least generous estimate (Harington’s invention installed for Queen Elizabeth I); several ancient civilizations developed forerunners.

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Yet, today, only half of India’s households have flush toilets. The other half will soon get them.

The democratization of this technology is more important than the Apple Watch or Google Glass. So is an African buying his first car, 130 years after Daimler. Standards of living are improving rapidly enough in the developing world that this democratization is taking place right now. Investors can participate, directly or indirectly, in the gains in well-being from technology diffusion. (Exactly how is a topic for a professional equity analyst, not for me.)

In 1899, the satirical magazine Punch opined that everything that can be invented had already been invented. The timing of this wisecrack was perfect. An explosion of invention immediately followed. Four years later, two men would fly a few hundred feet. Sixty-six years after that, we flew to the moon. That is the pace of improvement humans are capable of when we set our mind to it and have the right incentives.

It is 1899 all over again. Don’t be afraid of the future.

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10 “The Coming Century,” Punch, January 4, 1899. This quote is often unfairly attributed to the head of the U.S. patent office, Charles Duell, who believed the opposite.
"I like to think we aren't so much anti-science as we are pro-myth."