



MARKET OUTLOOK

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Siren song of high returns can lure investors into catastrophe

By Flint Stephens

In Greek mythology, sirens were creatures with bird-like bodies and the heads of women. They lived at the edge of the sea where rocks posed grave danger for ships that ventured too close.

The sirens could enchant any man with their beautiful music. Powerless to resist, sailors who heard the siren songs would dive into the sea or steer their ships onto the rocks where certain destruction awaited.

The sirens were not benign. Their objective was to feast on the sailors who ended up stranded on the rocks.

Odysseus defeated the sirens by ordering his men to put wax in their ears so they couldn't hear the music as they sailed by. He ordered his men to tie him to the ship's mast so he could hear the enchanting sounds but wouldn't be able to succumb to their alluring tunes.

Today's sirens are alleged market experts who woo investors with promises of high returns and secret investment methods. They broadcast their music through investment newsletters and as guests on financial news media.

When the market is rising, their lyrics go something like this:

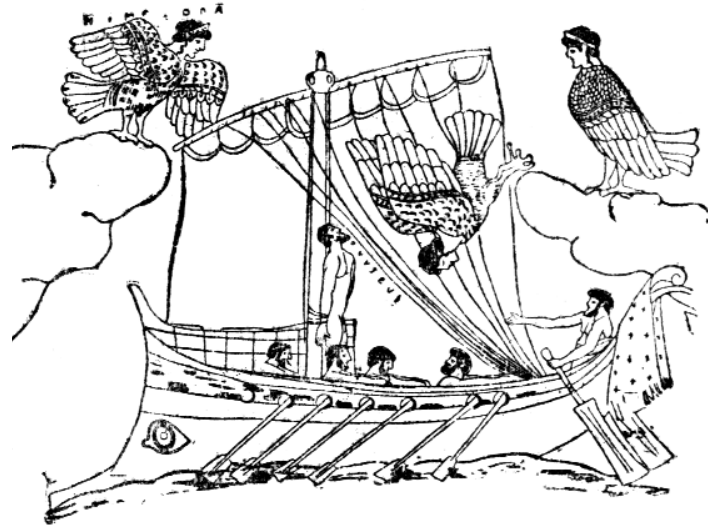
*"Stocks are up, your assets rose
and while that's really nice,
Imagine how much more you'd have
If you followed my advice."*

For many investors, the song is irresistible. They are so captivated by the music that they don't see the dangerous rocks. And they never realize that the investment-guru sirens are eager to profit from their misfortune.

Alexander Elder wrote about the allure of these gurus in a book called *Trading for a Living*. He noted that these popular experts have existed ever since the public entered the markets.

"Guru manias spring up faster now than they did centuries ago, thanks to modern telecommunications. Even educated and intelligent investors and traders follow market gurus, like devotees of the false Messiahs in the Middle Ages."

Perhaps you have wondered why these experts don't work for major investment firms. After all, if their methodology is so good, you would think that firms like Fidelity or



Merrill Lynch would deluge them with offers. Here is Elder's explanation for that:

"Gurus always come from the fringes of market analysis. They are never establishment analysts. Institutional employees play it safe and never achieve spectacular results because each uses similar methods. A market cycle guru is an outsider with a unique theory.

"A guru usually earns a living publishing a newsletter and can grow rich selling his advice. ... At investment conferences, a guru is surrounded by a mob of admirers. If you ever find yourself in such a crowd, notice that a guru is seldom asked questions about his theory. They are content to drink in the sound of his voice. They brag to their friends about having met him."

I have worked for several of these gurus in the past 20 years. Some are honest and sincere. Most are very intelligent. But those traits do not qualify someone to be a good investment manager.

As a group, the trait that most defines them is their need for public adulation. Most are much better entertainers than they are investment managers. Many are arrogant. Few are willing to admit mistakes.

Their desire for recognition and its accompanying success is so great that they are often willing to embellish the truth when it comes to their accomplishments. Usually this embellishment is presented as misleading half truths rather than outright lies.

For example, one nationally known siren used to send out articles about his system that looked like they were

clipped from a newspaper. The article raved about the success of his program and was meant to appear as a legitimate news story. He had the stories printed on newsprint and he even had stock quotes printed on the back so it appeared to come from the business section.

People responded well to this ploy because many thought that if a newspaper were printing such a positive story about his system, it must be legitimate. While this man's actions weren't illegal, they certainly were less than completely truthful.

Performance numbers often far from accurate

Another investment newsletter writer who also manages investment accounts recently sent out marketing materials touting the impressive performance of the portfolios recommended in his newsletter.

Unfortunately, his newsletter portfolios have often been much different than the activity in the accounts he manages. Buy and sell dates don't correspond, fund selection is often different and the reported newsletter performance does not deduct the impact of management fees or transaction costs.

In addition, the newsletter portfolio performance is calculated by calendar year. In other words, a position that ends the year with a loss is figured at a zero balance to begin the next year. But an investor holding that loser does not have that luxury. His account remains in the red.

This advisor markets and advertises the outstanding performance of his newsletter portfolios. His marketing literature never states that the track record for managed accounts is much lower. Under SEC regulations, what he is doing is questionable and probably illegal. Yet he constantly adds new clients taken in by his siren song promising spectacular returns.

Another guru/siren sent an email where he boasted of recommending 12 stocks that gained anywhere from 58% to 330%. There is no mention of any losers. Pretty impressive—Peter Lynch and Warren Buffet will probably soon be asking for his investment advice.

Unfortunately, many investors who heard that music were undoubtedly entranced, thinking to themselves: “Even if I only make half as much, I'll soon be richer than I ever imagined.”

These guru/sirens are often quoted in the mainstream media or interviewed on financial programs, which again appears to add to their legitimacy. But the media do not try to verify the accuracy of their claims. They interview them because they are popular or because they are outrageous.

Again quoting Elder:

“When a guru becomes accepted by the mass media,

it is a sign that he has reached his crest. When several magazines devote space to a hot market guru, you know that his end is near.”

Chasing high returns can lead to investment ruin

Investors who succumb to these sirens allow greed to overcome reason. Chasing performance is the biggest mistake most investors make.

A prominent investment research firm recently completed a study on the performance of top-ranked mutual fund managers. It showed that investors would generally achieve better returns by placing money in the previous year's worst-performing funds than in those that had the best return.

Remember the lesson of 2000? Triple-digit returns of the Nasdaq 100 in 1999 convinced many to switch all their assets to high-tech stocks and funds. In ensuing months, the Nasdaq experienced its worst-ever decline.

Historically, any investor or professional money manager who earns an annualized rate of 10% over a couple of decades will be in a rare minority. Yet most investors believe they have the skill to do much better.

For example, if a talking head on CNBC announces that the Nasdaq is up 30% in the past three months, an investor hearing the report automatically starts calculating the return on his investments for the same period. Invariably, it will be less and the investor wonders why his portfolio isn't keeping up with the index.

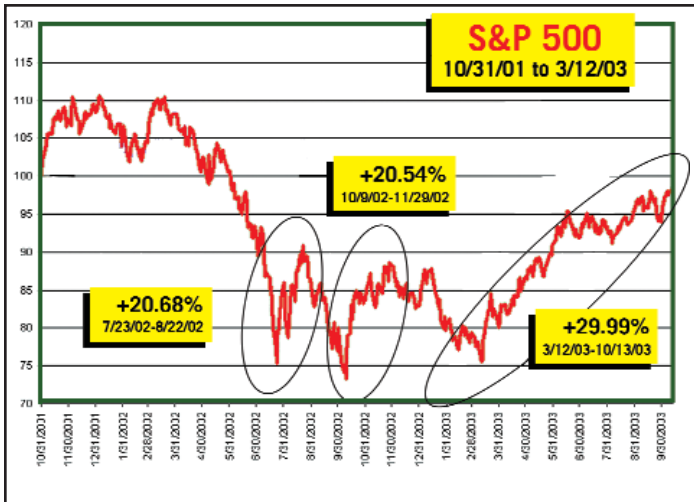
It never occurs to him that because of his needs and situation the Nasdaq might be a totally inappropriate investment vehicle. All he understands is that another investment has better performance and he wishes he had the additional reward.

The indexes we hear about most—the Dow, the S&P 500 and the Nasdaq—are all quite volatile. In fact, they have so much volatility that normal investors find it almost impossible to weather the fluctuations.

The accompanying chart shows the dilemma that confronts investors. During the period depicted, the S&P 500 lost money. Yet in the midst of a serious bear market, there were some nice rallies.

The nature of investors is to look at a chart like this and think, “If I invest in the index during the rallies, and then move back to cash at the beginning of each down

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turn, I'll make even more money."

Notice that the sharp rallies in the index are usually preceded or followed by serious corrections. Even the brightest minds in economics cannot accurately predict when the corrections will come or how severe they will be.

Many investment guru/sirens claim to have reliable systems for forecasting what the markets will do. (If they could really do what they claim, Wall Street firms would beat down their doors with salary offers that would make professional athletes seem like paupers.)

Our experience at Strategis has taught us that the very best market prognosticators won't always be right. Unfortunately for those who rely on these experts, a single wrong guess can spell disaster for a retired investor's portfolio.

One of the guru/sirens mentioned above went through a period of several losing trades in a row in his managed accounts. The cumulative draw-down exceeded 40% (he neglects to mention this in his promotional literature).

Most investors cannot endure such a correction. They bail out at some point and find themselves clinging to a rock with the wreckage of their portfolio floating in the sea around them.

Avoiding losses key to getting and staying ahead

A wealthy friend achieved success in several diverse business ventures as well as in investing. He revealed his secret for financial success as this: "If you watch the pennies, the dollars will take care of themselves."

Knowing that he cannot perfectly forecast what the market will do, a wise investment manager must evaluate each juncture from a perspective of risk rather than reward.

In other words, when he enters an invested position, instead of thinking, "How much can I make if I am right?" He must instead consider, "What is the most that might be lost if I am wrong?"

Investors tend to be motivated by greed or by fear. Of the two emotions, it is easier to appeal to greed. So that is the route the investment guru/sirens take. They emphasize

potential returns and rarely say anything about risk. Yet risk should be the overriding concern of every investor.

When the subject of risk is raised, most of these sirens try to minimize those concerns. Some claim to have methods of avoiding any risk. But removing the risk from investing is as impossible as eliminating the risks of driving. And just as high speed increases the risks of driving, seeking higher returns **always** increases investment risk.

A guru/siren rarely makes any attempt to understand the financial situation of a potential investor, even though securities regulations require that any investment advisor make recommendations appropriate for the client's specific situation.

The siren offers a one-size-fits-all solution. His song will always be about his theory and his expertise. He doesn't listen to the client's wants or understand the client's needs. And if those objectives are unrealistic, the guru/siren certainly won't take time to educate the client.

For example, if a couple needs an 8% annualized return to meet their retirement financial objectives, they can probably reach that level by investing primarily in low-risk vehicles.

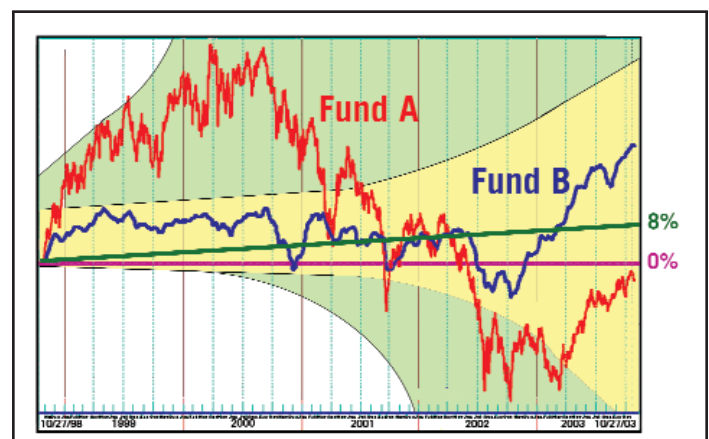
The statistical probability of achieving a profit target increases by selecting low volatility investment options that hover near the objective.

The accompanying chart shows the performance of two hypothetical funds over a five-year period. Fund A is an index fund that correlates closely to the S&P 500. Fund B is a high-yield bond fund. The green line represents the 8% annualized return the couple needs.

Based on its volatility, the shaded yellow area represents the range of probable returns for Fund B for the period depicted. The green shaded area represents the range of probable returns for Fund A over the same time.

Because Fund B hovers near the 8% line for most of the period depicted in this chart, the chance that it will be achieving its objective at any given point is fairly high. While Fund A exceeds the objective for much of the period, there are points when it falls significantly behind.

During the time shown in this chart, an investor hold-



This chart is hypothetical and for illustrative purposes only.

ing Fund B would achieve the 8% annualized objective while someone holding Fund A would not. Along the way, the investor with Fund B would probably experience less of an emotional roller coaster because of its lower volatility.

The guru/siren lures investors by promising to put their money in Fund A during periods of sharp rallies and then move it to Fund B when the market corrects. “By so doing,” he sings, “I can get you 20% a year rather than the 8% annual return that you need.”

At this point anyone hearing the tune needs to learn a lesson from Odysseus. They should cover their ears and flee, because the siren’s plan is one of financial destruction. If they succumb, laws of probability and economics almost guarantee they will not achieve their objective.

There is an asymmetrical relationship between risk and reward. In other words, once an investor begins losing money, it becomes much more difficult to get back on track.

In our prior example, consider what happens if an investor seeking an 8% annualized gain instead loses 8% in the first year. In the second year, he must gain almost 27% to make it back to his objective. Preventing losses does far more to increase the probability of his objective than trying for a home run in a highly volatile investment.

In contrast, the guru/siren’s reasoning is likely to go something like this:

“You want an 8% return. Last year my recommendation made 40%. So even if it only does half as well this year, you’ll still have more than double what you want. You’ll meet your objective even if it only does one-fourth as well.”

His reasoning is just as flawed as that of a track coach who tells a high jumper that the best way to clear six feet is to set the bar at 12 feet.

Investing is like climbing an icy mountain slope. Gaining altitude is difficult. If the climber slips and tumbles down the hill, all his momentum is then going the wrong direction. If he is able to stop his fall, he must expend extra effort just to get back to his former altitude. If he hopes to regain lost time, he must climb faster, increasing the risk of another fall that could delay him even more.

These are the statistical realities that the guru/siren will never mention and probably doesn’t even understand. He ignores laws of probability. But they are as real and unforgiving as physical laws like gravity.

Aim for the mark

Guru/sirens usually apply a shotgun approach to investing.

A shotgun fires a shell that contains dozens of small pellets. When the gun is fired, those pellets disperse over an area called a pattern. This pattern generally covers about a 30-inch circle at 40 yards. The concept is that a smaller 6-inch target anywhere inside that pattern will always be hit by several pellets. But the vast majority of

the pellets will always miss the smaller target.

If the target is farther away— say 70 yards— the pattern is likely to be so spread out that none of the pellets will strike the smaller circle. At 100 yards, the small pellets have lost most of their energy fall harmlessly to the ground without even reaching the target.

In contrast, a rifle shoots a single bullet that is much larger than the shotgun pellets. The bullet is fired at a much higher velocity and is designed to spin as it travels. This greatly enhances its accuracy. With the proper rifle, a moderately skilled marksman can hit a six-inch target at 300 yards. A truly gifted marksman might be able to stretch that to 500 yards.

For most investors, financial goals are like a small, distant target. Good investment managers recognize that the best chance of hitting that target is to use the best available marksman and the most accurate rifle.

Guru/sirens try to divert attention from those distant targets. They talk about the beauty and craftsmanship of their shotgun. They try to dazzle investors with the array of recommendations in their shotshell. They point out the number of hits in the target at 30 yards without mentioning the misses. They completely ignore the fact that their weapon of choice isn’t even capable of hitting a target 300 yards away.

Cover your ears and run!

As the economy improves and the market continues to advance, more and more of these sirens will start to sing. Their music will resonate from financial networks and printed versions of their lyrics will show up in your mailbox and email.

*“Stocks are up, your assets rose
And while that’s really nice,
Imagine how much more you’d have
If you followed my advice.”*

Next time instead of listening and second guessing your long-term investment plan, remember the lesson of Odysseus. Plug your ears, tie yourself to the mast and keep the course.

Unlike the investors hypnotized by the evil sirens, you’ll sail past the dangerous rocks and reach your financial destination with your ship and crew intact.

Flint Stephens is the marketing director for Strategis Financial Group. He has a master’s degree in communications from Brigham Young University. He has written and edited many investment newsletters.

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