INVESTMENT STRATEGY
IN AN
UNCERTAIN WORLD

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Also by Harry Browne

How You Can Profit from the Coming Devaluation (1970)
How I Found Freedom in an Unfree World (1973, 1998)
You Can Profit from a Monetary Crisis (1974)
The Complete Guide to Swiss Banks (1976)
New Profits from the Monetary Crisis (1978)
Inflation-Proofing Your Investments - with Terry Coxon (1981)
Investment Rule #1 (1985)
Why the Best-Laid Investment Plans Usually Go Wrong (1987)
The Economic Time Bomb (1989)
Why Government Doesn't Work (1995, 2003)
Fail-Safe Investing (1995, 2003)
The Great Libertarian Offer (2000)
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INTRODUCTION

March 1, 2008

Harry Browne’s Special Reports opened for business by publishing its first newsletter issue on December 24, 1974.

By the end of the 1970s Harry had come to the conclusion that forecasts were pretty useless.

He said, "If the world is running out of trees, it is because so many people have used so much paper to write so many words about so many inevitable events that never came to pass."

In March 1980, he wrote "Forecasting vs. Strategy," in which he said that profits come from a good strategy, rather than accurate forecasts. As the decades progressed he became progressively more anti-prediction. And he published many full-length articles explaining why it’s impossible to predict human action — no matter how simple it may seem.

This book contains 16 of those articles that discuss Harry’s investment strategy. They contain perceptive explanations that debunk so much of what passes for investment wisdom — plus intelligent comments about life. Most of all, the main thrust of the articles is a step-by-step analysis of how you can deal with an uncertain world — without preconceptions or dogma.

These articles will remind you of something you learned a long time ago – that the future is unknowable. They will also reassure you that you don't have to rely on fortune tellers to deal successfully with any part of you life -- including your investments. And they’re written in Harry's patented easy-to-follow style, sprinkled with his good humor.

Although these articles were written in the 1980s and 1990s, they contain ideas that are timeless – ideas that can help you today to separate sound investment advice from slogans masquerading as insight.

I hope you enjoy the book.

Best wishes,
Pamela Wolfe Browne
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22 YEARS BEFORE THE KEYBOARD

July 23, 1997

HARRY BROWNE'S SPECIAL REPORTS opened for business by publishing its first issue on December 24, 1974.

Over the succeeding 22½ years, the newsletter published investment analysis, investment suggestions, political commentary, alleged humor, investment crossword puzzles, explanations of esoteric economic and investment subjects, analyses of the investment implications of numerous new tax laws, graphs and more graphs, a contest to guess in advance the date of the Mexican peso devaluation and one for the Japanese stock-market crash, tables of weekly investment prices, news summaries, examples of faulty press reporting about the economy and investments, quotations from others on politics and investing, refutations of common investment and political clichés, apologies for typos and late issues and late articles, and assorted persiflage.

During that time there were very few predictions or forecasts, almost no self-congratulations, no pictures of trendlines or head-and-shoulders patterns, no information from well-placed sources, no sure things, and less than enough discipline.

3 Phases

The newsletter evolved through three phases.

The first was from 1974 to 1978, when it was concerned almost entirely with hard-money investments and the deteriorating state of the U.S. economy.

The second, from 1978 to 1986, was a transition phase — from a preoccupation with hard-money investments and thoughts of a dismal future toward the current complete reliance on a balanced Permanent Portfolio.

The third, starting in 1987, has been a period relying solely on the Permanent Portfolio — with constant warnings against thinking some plausible story could tell you how to time your investments —how to know when gold was going to rise or the stock market was going to fall.

Phase I: The Hard Money Newsletter, 1974 – 1977

HBSR wasn’t the first hard-money newsletter. When we began on December 24, 1974, such eminent hard-money writers as Harry Schultz, C.V. Myers, James Dines, Jerome Smith, and Franz Pick had already been in business for years. And Richard Russell, while not known for hard-money views at the time, had been publishing for over a decade before we started HBSR.

In the newsletter’s first phase, the content was heavy on such matters as privacy, Swiss banks, silver statistics, news of Switzerland and its economy, cost-of-living indices worldwide, tables showing the gold backing of major currencies, retreats, how to obtain Swiss residency, and other topics that might have seemed exotic — or even kooky — to the average investor.

Phase II: The Transition, 1977 – 1986

Starting in 1977, I tried to look ahead to the end of the hard-money era.

We had already introduced Terry Coxon’s idea of using warrants as a low-cost way of being able to profit if a bull market in stocks caught us by surprise. And in December 1977 the first rudimentary version of the Permanent Portfolio was presented.

It wasn't called a Permanent Portfolio; it was a single portfolio that contained several permanent elements, but included a section for short-term investments. Then in November 1978 the two-portfolio concept was introduced — with the names Permanent Portfolio and Variable Portfolio.

In its first incarnation, the Permanent Portfolio was simply a long-term portfolio — meant to include whatever you expected would do well over a period of many years. The Variable Portfolio was a short-term portfolio, acting on what you expected to happen in the near future.

The idea was that the Permanent Portfolio would hold long-term positions in the hard-money investments, with some hedges — while the Variable Portfolio would get you into bull markets in gold or stocks or whatever the near-term outlook seemed to warrant.

But the tone of the newsletter was definitely changing: for the first time, for example, Treasury bonds and bills were considered legitimate investments.

As the 1980s began, with Terry Coxon's help I developed a more open attitude. And he and I offered a set of sample Permanent Portfolios that allowed each investor to act on his own expectations — whether for prosperity, level inflation, rising inflation, runaway inflation, deflation, or "I don't know." Eventually, the "I don't know" portfolio was the only one I'd discuss.

Back in the late 1970s, however, the hard-money era was still alive and thriving. 1979 and 1980 were the most exciting investment years any of us is ever likely to see. Gold started 1979 at $226 but was at $850 by January 1980, and then back down to $481 by March 1980. Silver began 1979 at $6.07, shot up to $48 in January 1980, and was down to $10.80 by May 1980.

During 1979, living in Zürich, I used to wake up in the early afternoon and check the Reuters screen sitting by my bed — to see how high gold had risen at the New York opening — and how much money I’d made while asleep. Ah, those were the days.

But it was obvious that this couldn’t go on forever.

And in January 1980, in issue 39, we published “Farewell to Silver” (excerpts below) — at a time when silver was in the mid-$30s.

And in April 1981, I wrote that the legendary silver shortage had disappeared — so that we shouldn’t expect ever again to see a silver bull market like that of the 1980s.

And although I never gave up on gold for the Permanent Portfolio, I knew in 1980 that the big move was over. Short-term holdings of gold were sold at prices around $600 in the Spring of 1980. We had already dropped out of the Swiss franc at $.50 in 1978. In March 1981 we published, “Hard Money Investments — The Wave of the Past.”

Of course, in true newsletter fashion I’m giving you only the good news. I won’t go into our adventures with put options, Treasury bonds, and a half-dozen other ill-fated, short-term speculations.

By the end of the 1970s I had come to the conclusion that forecasts were pretty useless. In March 1980, I wrote “Forecasting vs. Strategy,” in which I said that profits come from a good strategy, rather than accurate forecasts. And as the decade progressed I became progressively more anti-prediction.

We published many full-length articles attempting to explain why it’s impossible to predict human action — no matter how simple it may seem. And as writers continued to send forth more and more predictions, I took to publishing their prior year’s predictions (without identifying them by name) — in order to throw cold water on the new ones.

Phase III: the Permanent Portfolio Strategy, 1987 –

The Permanent Portfolio reached its present shape in 1987, when I, at first, intended to update my recommendations of a few years before. Instead I realized that it made no sense to offer anything but a single portfolio that could protect you no matter what may come.

By this time I was a complete agnostic as to the future — and an almost-complete agnostic with regard to investment analysis, hanging on only to a few strands of fundamental and technical analysis that broke not too long afterward. However, I continued to keep a model Variable Portfolio and made suggestions until 1994. After that I continued to encourage readers to bet on anything that seemed attractive to them — so long as they did it with money they could afford to lose.

VITAL STATISTICS

Over 22½ years, the newsletter has contained 5,054 pages — an average of 26 an issue. The shortest issue was only 8 pages (issue #40 in March 1980), and the longest was 54 pages (issue #54 in October 1981).

I originally resisted the idea of writing a newsletter because I didn't want to be bound by deadlines and have to write something when I had nothing to say. The publishers suggested making the newsletter's frequency irregular, so that we would send out issues only as warranted.

Each subscription was for 10 issues, not a calendar period. The interval between issues ranged from one week (in 1975) and 17 weeks (in 1976) — averaging 6 weeks. The time it took to fulfill a 10-issue subscription ranged from 11 months to 19 months, averaging 14 months. There was an average of 8½ issues published per year.

MY WRITING

As I read through the first 190 issues in preparation for this final issue, I was impressed with how good some of the writing was — incisive, uniquely appropriate, original, entertaining, and informative. I read many things I had completely forgotten and was glad to be reminded of.

But I also was embarrassed as I reread a number of things I’ve written. Some of it is naïve, some of it completely inappropriate for an investment newsletter, some of it even immature to my 1997 years.

There were perceptive explanations that debunked so much of what passes for investment wisdom — plus intelligent comments about politics and life. Most of all, the main thrust of the past decade has been a step-by-step analysis of how you can deal with an uncertain world — without preconceptions or dogma.

Alongside this useful wisdom, however, was a certain amount of meaningless dribble about the possibilities for the economy and investment markets — a lot of earnest words signifying nothing.

I’ve always felt there were five subjects about which people pontificate knowingly and endlessly without any real knowledge — politics, psychiatry, investments, diet, and exercise. Perhaps it’s fitting that as I reduce my investment writing, I will increase my political writing.[1]

There are some examples later in this article of my concern about the endless investment talk that leads to nothing substantial. If the world is running out of trees, it is because so many people have used so much paper to write so many words about so many inevitable events that never came to pass.

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[1] Check the bookstores for the debut of my new book How a Permanent Portfolio Can Bring You Physical & Mental Health, Extreme Wealth, Personal Liberty, & Washboard Abs.

Even though I haven't been alone in talking about what can't possibly be known, I still regret wasting so much of my own time and the readers' time in conjecture about things that might or might not ever come to pass.

The wonderful thing about being a writer is that what you do lives on long past the time you do it. The bad thing about being a writer is that what you do lives on long past the time you do it.

STRENGTHS & WEAKNESSES

I'm probably the least objective person to be appraising the newsletter's strengths and weaknesses, but if I open the door to others to write this article, who knows what indignities I might suffer?

As I look through the back issues, I see some traits that must have driven many subscribers to distraction:

- Issues that took many weeks to show up. This was partly caused by one of the newsletter's strengths, as described later, but it must have been nerve-wracking if you had a speculative investment that wasn't doing well and you weren't hearing from the fellow who had led you into it.
- Apologies for late issues and articles promised but not delivered. I knew I shouldn't announce articles in advance, but I couldn't seem to keep my mouth shut.
- A multitude of corrections of typos or incomplete information.
- New features added with great fanfare, only to be dropped not too much later without a toot.
- The repetition of the same points over and over again — the idea that gold will never enter a major bull market so long as inflation remains subdued, the constant harping that the only way you can rest assured you're covered is with a Permanent Portfolio, and on and on and on.

But I also see many strengths that were unique to the newsletter:

- Detailed instructions for making every investment suggested.

- Scrupulous attention to the transaction costs and actual purchase/sale date of each suggested investment, so that the reported performance results were realistic.[1]
- More than a perfunctory respect for risk. Instead of guessing how low an investment might go, we set stop-losses on all Variable Portfolio investments and tried to recognize every way that a speculation could go wrong.
- Detailed explanations of activities in the investment world — how governments intervene in the currency market; how trusts operate; what derivatives are and what distinguishes whether they are investments or speculations; how dollars held through foreign banks are actually held in the U.S.; and so on.
- Answers to hundreds of questions posed by subscribers.
- Making sure I could prove any of my assumptions — no matter how popular the assumptions — which led in some cases to changing my mind. Sometimes this checking led me down paths of analysis that caused newsletter issues to be published later — or even much later — than I'd expected.
- Careful, considerate writing — thanks in part to the world's best editor — that always made sure the reader could follow, understand, and enjoy what was written.
- Graphs that clearly showed and explained the history of an investment or economic indicator, so that one didn't have to be an experienced chart-reader to follow them.
- The repetition of the same points over and over again — the idea that gold will never enter a major bull market so long as inflation remains subdued, the constant harping that the only way you can rest assured you're covered is with a Permanent Portfolio, and on and on and on. Maybe they sunk in eventually.

Warnings

1 Prior to the stock market crash on Monday, October 19, 1987, the Variable Portfolio was partly invested in mutual funds. I had instructed readers to sell as soon the NYSE Exchange Composite Index closed at 170 or less. That happened on Thursday, October 15, 1987. Since this applied only to active Variable Portfolio speculators, we assume most of them were aware of the signal and sold their mutual funds on Friday, October 16 — prior to the Monday crash. However, we had a policy of crediting purchases and sales two market days after any signal was given. So we posted the Variable Portfolio's sale on the day of the crash. This put us in the ironic position of publishing a poorer performance record than the newsletter rating services gave us.

From the beginning, the newsletter dealt in warnings.

But these have stepped up considerably in the last ten years or so — as I attempted to keep you from forsaking a balanced, safe portfolio in favor of someone's idea of a sure thing or someone's misguided thought that a particular kind of event — whether a crisis or a boom — was inevitable.

There were cautions against:

- Accepting the common clichés of the investment world;
- Believing that silver was going to $100;
- Betting all you have on runaway inflation, deflation, or any other scenario;
- Investing in things you don't understand but sound good;
- Keeping too much of your wealth in any one investment, in any one country, or with any single institution;
- Treating as fact what financial reporters write;
- Worrying about the Depression of 1990 or Bankruptcy 1995;
- Believing that the U.S. government will be allowed to peek into your Swiss bank account;
- Being beguiled by trading systems, moving averages, waves, Fibonacci numbers, numerology, Gann squares, or Tarot cards;
- Paying any attention to the Kondratieff Wave;
- Expecting gold to profit from any world crisis if it isn't already in a bull market caused by rising U.S. inflation;
- Believing that the Arabs, the Japanese, a united Europe, or China posed a threat to America's economic future;
- Taking seriously the "new currency" scare;
- Believing the dollar is going to die;
- Treating the U.S. trade deficit, the decline of manufacturing, or the "debtor nation" scare as anything other than a non-problem;
- Excluding bonds from your portfolio in the 1980s or excluding gold from your portfolio in the 1990s;

- The idea that insider trading or program trading was a threat to the financial markets, or that Michael Milken was your enemy — when, in fact, all three served to make the investment markets more efficient.

I feel like a fireman who has run to put out 2,000 fires — and who hasn't always succeeded.

The 190 issues attempted to refute a multitude of statements from people who explained why, for example, gold at $375 had to rise or the Dow at 3,000 had to collapse.

The failure of such alarms to materialize into anything real or profitable never dissuades the alarmists from continuing to come up with new reasons that, for example, gold at $325 has to rise or the Dow at 7,000 has to collapse.[2]

During the past two decades I've received scores of letters from subscribers recounting someone's plausible story explaining the inevitability of some coming crisis or "explosive" bull market, or detailing a sure-fire indicator or trading system. My job has been to point out that nothing like this has worked out before (which should inspire you to be very skeptical that this idea will), and go on to explain the specific fallacies that doom this particular sure-thing to failure.

One article ("The Great Inflation-Deflation Debate" in 1984) listed 22 arguments that had been floated in the investment world to demonstrate that a return of severe inflation was imminent and inevitable, plus 26 arguments showing that deflation was just around

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[2] Throughout almost the entire life of the newsletter, my policy has been to withhold the name of any writer I criticize if he's in the investment newsletter business (to protect the guilty), while identifying anyone whose views I quote approvingly (to praise the innocent). I have, however, identified the authors of all political statements and all articles I've quoted from the financial press.

the corner. A rebuttal was given for each of the 48 arguments. It’s a dirty job but someone has to make money doing it.

Repetition

Having answered some of the same questions — such as on the supposed dangers of a new currency or central banks selling gold — so many times, I no longer give a thought when I come across a question I’ve answered before.

Thus I wasn’t amazed when I read through all the issues this past week and discovered that two questions answered in issue 186 had already been answered in issue 185.

AND NOW, WITHOUT FURTHER ADO . . .

I looked back through the 5,000 pages of the first 190 issues for excerpts that were typical of various facets of the newsletter. I pulled out enough to fill several articles the size of this one. I’ve pruned it down to what I hope you’ll consider a manageable size. I wish it could be more — not because I’m proud of it all, but because I think most of these items concern matters that an intelligent investor should think about.

Here, then, is a sampling of remarks from 190 issues and 22 years of Harry Browne's Special Reports. The items are just as originally published, except that most of them have been cut so as to fit them all in.

For long-term subscribers these excerpts can serve as reminders of important points. For newer subscribers or non-subscribers, I hope this summary of a unique approach will help you see your investments in a new light — one that will make it easier for you to deal with an uncertain world. And to keep it from being too grimly serious, it's all interspersed with some fluff that I hope will entertain you. [4]

The Economy, Government, & Society

From its inception, the newsletter included a large amount of economic and political commentary — some of it related directly to investments, while other comments were just spouting off. Of course, as with investment commentary, a good deal of it now seems naïve and irrelevant. But here are some items that I hope remain instructive today.

BASHING SCROOGE

December 3, 1986

TV Guide, in its November 22-28 issue, had this to say:

> Jeers to Wall Street Week panelist Martin Zweig . . . he asked a guest expert who predicted a devastating epidemic of AIDS to recommend some stocks that might go up as a result. It's enough to give capitalism a bad name.

This is another example of the warped view that many people have of investors, investing, and the markets.

It's fun to be holier than thou, and to picture Mr. Zweig as just a heartless money-grubber. But it isn't very enlightening. . . .

If TV Guide really believed that no one should profit from the misery of others, it would stop selling magazines that refer to AIDS, poverty, or other national problems. Fortunately, neither TV Guide nor any other publication does believe that, and so we have the benefit of what they publish.

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[4] In most cases, these are excerpts from longer articles. You can obtain a complete copy of any issue for $15 by calling the newsletter office at (800) 531-5142 or (512) 453-7313.

We also have the benefit of investors with capital. Diseases like AIDS can be defeated fastest if profit-seeking investors put capital into the companies that are working on cures. And the more investors know about the prospects of companies, the more efficiently the capital can be distributed.

Individuals pursuing their own self-interest wind up helping others. And that's what gives capitalism a good name.

INSIDERGATE

May 6, 1987

The whole discussion of insider trading tends to get muddied by the unspoken assumption that investors have a "right" to a certain kind of treatment. Why do they?

When people think about dealing with any company, they accept the company as it is — and decide whether or not to do business with it. They should approach investing in the same way.

The New York Stock Exchange doesn't owe anyone a living, a profit, a "level-playing field," or anything else. People who don't like the rules shouldn't play the game. There are plenty of other markets in the world. And if it happens that most of the markets operate in much the same way, it isn't because there's a conspiracy among them; it's because that's the only system known to work.

The surest way to destroy the financial markets is to have the government guarantee that everyone gets what the government believes is fair treatment. I would rather take my chances with Ivan Boesky than with Ted Kennedy.

BILL CLINTON

July 28, 1993

Bill Clinton is without a doubt the most engaging, persuasive president this country has had in my lifetime — which goes back to FDR. Neither Ronald Reagan nor John F. Kennedy, each widely praised as a presidential charmer, could hold a candle to Mr. S. Willie.

In an interview, a news conference, or a prepared speech, Mr. Clinton comes across as sincere, down-to-earth, humble, extremely knowledgeable, and passionate about his beliefs.

But it's also true that, in a profession in which dishonesty is the first and foremost qualification, Bill Clinton stands head and shoulders above the pack when it comes to telling whoppers. I have never in my life seen a man for whom lies roll off the tongue with such ease.

And it's simply too much to believe that a man who seems to have stored so many facts and figures in his brain — ready to be trotted out whenever the appropriate question is asked — doesn't realize that what he's saying is completely opposite to the truth of the matter at hand. Not only that, too often what he says is completely opposite to what he said just a few months or days earlier — or even a few minutes ago.

On July 20, I watched him in action on the Larry King Show. In that wonderful, engaging style of his, the fibs came pouring out one after another.

Of course, all his stock clichés were there — this is the "first serious effort," "I've spelled out specific cuts,", "had to make the tough choices," "gays have served with distinction," "ask the rich to pay their fair share," and so on. Not to mention his #1 cliché — "the past 12 years" — which pops up at least every five minutes.

But beyond these vacuous phrases and the endless slogans were the misstatements, inconsistencies, twisted logic, invented facts, and — to put it mildly — barefaced lies.

One minute he said that all the savings from his plan were going into a trust fund to reduce the deficit — and that was an absolute promise on his part. The next minute he was saying there was plenty of money available for the Mississippi flood victims because, thanks to lower interest rates, the current year's deficit was lower than expected.

At five minutes past the hour he was saying we must encourage American businessmen to create more jobs. At quarter past, he was saying you don't have to worry about the tax bill because the rich (American businessmen, I presume) were going to pay almost all of it. By the half hour, he was railing as usual that the rich had gotten a free ride for — you guessed it — "the last 12 years." But by quarter of, he was back on their side again — saying that deficit reduction would lower interest rates enough that even the rich would come out ahead.

A particularly outrageous whopper was his statement that, because of his courageous efforts to finally "come to grips with the deficit," the recent Tokyo summit was the first time in (let's all say it together now) "12 years" that foreign leaders had treated an American president with respect. It seems they had been pleading for (ready now, 1-2-3) "12 years" for American presidents to do something to stop "sucking money from all over the world to pay for our deficits."

I guess at those state dinners Ronald Reagan was made to sit at the children's table.

Of course, Larry King's audience isn't likely to be aware that those foreign leaders have budget deficits of their own that are as bad as — or worse than — ours. And if Larry King were aware of that, he still wouldn't be likely to call attention to it and bite the presidential hand that's feeding him.

And, of course, Mr. Clinton bragged about having brought interest rates down. To hear him tell the story, you'd think that interest rates had been rising steadily for the past, well, 144 months — until they suddenly started plunging last November when the world saw that "change" was in the air.

But . . . the downward trend in long-term rates was in motion long before last November — and the long-standing downward trend in short-term rates came to a halt in October when it became apparent that Mr. Clinton had the election sewn up.

With his patented abandon, a few minutes later Mr. Clinton flip-flopped and took credit for the fact that short-term rates aren't falling. Thanks to his "serious efforts" to do you-know-what after you-know-how-long, short-term rates have stopped falling — allowing long-term rates to come down to join them. Apparently, economic Nirvana means having no spread between short and long interest rates.

And, lastly, in his latest installment in the continuing evolution of "how little the tax increase will cost you," he said that you'll pay only $1 a week in higher gasoline taxes. The rest will come from soaking the rich. The preceding week on the same show, a Democratic flack had said it was $25 a year. In the State of the Union address, it had been $17 a month. Tomorrow's figure is likely to be 38½¢ a day.

The current campaign to sell the budget deal is focused on the idea that those who oppose it have the crazy idea that a tax increase will cost them something. Administration spokesmen, starting with Mr. Bill and supported by journalistic sycophants like Larry King, run around asking people how much they earn and then reassuring them that they won't be affected by the tax increase.

After all, the deficit is going to be reduced entirely through spending cuts that are guaranteed to take effect the day after the Messiah returns, and by taxing the filthy rich retroactively from the time of the Messiah's first visit.

FAMILY BORROWING vs. GOVERNMENT BORROWING

February 36, 1995

We're told . . . that families borrow and companies borrow, so why shouldn't governments borrow? The difference is (and why, pray tell, must it even be necessary to explain this?) that families and companies must pay back what they borrow — and pay it back out of their own earnings — so most people borrow with care.

Politicians make no plans to repay what they borrow, they don't even notice which spending program will be financed out of revenues and which will require borrowing. And when they leave office, they accept no personal responsibility for paying back the debt — they just collect their pensions. In other words, they are unaffected by the eventual consequences of borrowing — and so they feel no restraint.

<u>That</u> is the difference between family borrowing and government borrowing.

FIGHTING CHILD LABOR

July 28, 1996

Today there are places in the world that are no more advanced than America was a hundred years ago. In those places, children have to work to help support their families. And working conditions aren't exactly on a par with the comfortable offices in the U.S. Department of Labor in Washington.

But pressuring companies to stop employing workers in those conditions won't transport those workers to air-conditioned factories with Blue Cross plans and 3-week annual vacations.
It will simply put them out of work, and may even cause them to starve to death.

THE 1997 BUDGET DEAL

May 14, 1997

You may not have heard the details of the latest federal budget deal, agreed upon by Bill Clinton and the Republican Congress. But here's all you need to know about <u>any</u> budget deal:

1. The politicians will take credit for numerous "budget cuts," but the government will be bigger next year than this year.
2. The budget won't be balanced, but the politicians promise that some future Congress will balance the budget.
3. No Congressman will know the specific terms of the deal until long after he has voted for it — if ever.
4? Whatever tax cuts are included are insignificant compared to what you'll continue to pay.

The more things change . . .

An Uncertain World

Through the 1980s and 1990s I kept stressing the point that we live in an uncertain world. The trick, as I said over and over, is not to eliminate uncertainty but to find a safe way of dealing with it.

This respect for uncertainty led to the current incarnation of the Permanent Portfolio, which enabled investors to profit from the stock market boom and yet not be hurt when the market crashed in 1987. It also led to a certain measure of frustration for some readers.

HOW LITTLE WE KNOW

August 22, 1984

There are two amazing things about the investment world:

1. Things almost never turn out the way anyone expected; and

2. No one acknowledges the fact that things almost never turn out the way anyone expected.

Despite all the logic, the "proven" systems, the reliance on free-market economics, the superior wisdom — the simple truth is that very little turns out as investment advisors say things will turn out. . . .

Uncertain World

The beginning of investment wisdom is to realize that we live in an uncertain world, that we don't know enough about how the markets work, that we don't even understand the present fully, much less the future. This uncertainty is a problem only when you try to deny its existence. . . .

No matter what advice you receive, expect to be surprised — because you will be. Over and over again, A is supposed to lead to B, but instead it leads to C or gets swallowed up by D.

To me, the actual results are humbling. It reminds me, over and over again, how little I understand about how the world works — how little I know of natural law.

I believe many things. I have opinions on almost anything you want to discuss. But events keep telling me I <u>know</u> very little.

We live in a vast world that none of us can fully understand. We learn throughout our lives, but we are only chipping away at the ignorance — not eliminating it.

Growing Up

Throughout your entire life, you are only trying to grow up — to understand how to act, how to think, what to do to get what you want. Every year, you look back and say, “I didn’t understand everything last year, but now I won’t make those mistakes again.”

And you won’t make those mistakes again. You’ll make new ones. Every once in a while, I’m perceptive enough to remind myself that, if last year’s ideas seem so immature today, today’s ideas may not look so hot next year.

How You Live

The fact that we live in an uncertain world doesn’t mean there’s nothing you can do about your investments. You’ve managed to deal with the rest of your life successfully — in areas offering no more certainty than the investment markets offer.

In the real world, no one guarantees that you’ll have a job forever. But that doesn’t stop you from working and earning a good living.
Nor does anyone guarantee that your loved one will be with you always, but that doesn’t stop you from enjoying each other today, tomorrow, next month, next year.

Despite the uncertainty, you know there are ways to succeed in every other area of your life. Why not with investments as well? . . .

This Is it

There are no mystical secrets hidden behind the curtain that would enable you to read the future — in the markets or anywhere else in life. The world you see is the world you get.

There are no secret weapons, no guaranteed trading systems, no special indicators, no hot hands, no ways to beat reality.

We live in a world of uncertainty. Safety, profit, and peace of mind begin the day you quit wishing you could find an infallible system and start devising a strategy based on uncertainty. . . .

TALK, TALK, TALK

February 23, 1988

I have written so much about the futility of forecasts that you may be sick of it by now. But I still don't feel that I've said it all. I'm missing something that remains to be said.

It isn't just forecasts. It's 90% of what's written about economics and investments. It's all just talk.

The investment world is drowning in words — words about the significance of what just happened, somebody's explanation of what is significant in his favorite investment category, a projection of what the present is leading to, the "fact" that sooner or later some event is inevitable.

And yet almost all these interpretations appear hopelessly naïve if read 6 months or a year later. But still we read and listen and sometimes act on such statements — as though experience had shown that they might have some value. . . .

We listen endlessly and avidly to people pontificating on the past, present, and future — as though they really had something to say. Are we simply investment junkies, addicted to talk that does us no good but is habit-forming?

HISTORY DOESN'T REPEAT ITSELF LITERALLY

May 4, 1993

Low dividend yields are traditionally considered to be forerunners of a market peak. And those who feel bound by the precedents of history scoff at any suggestion that times may have changed. The "history repeats itself" argument might be summed up as:

> Whenever the tail-end of a bull market sends the dividend yield to a low point, the bulls search for reasons to believe that this time things will be different — that new conditions justify such a low dividend yield. But each time the limits of the market assert themselves and bring great losses to those who refuse to learn from history.

I agree that it's foolish to ignore history. But it's just as foolish to believe that history has fixed a limit on how far something can go. The truth is that there is no limit to how low the dividend yield can go — short of zero.

The record that seems today to be an absolute limit was itself once considered unlikely because it had never before been reached. I suspect that when the dividend yield dropped to 3.5% in the late 1950s, a lot of investment analysts warned that a market top was nigh — since 3.5% had never been breached before. But the market continued higher, and yields continued to fall until they bottomed at 2.84% in 1961.

In fact, conditions do change as the decades pass — establishing new standards and new apparent limits. History doesn't repeat itself — not literally, nor even figuratively. People learn from experience, they change, and they change institutions. Otherwise we'd still be trying to figure out how to cross the river Jordan. . . .

The only lesson that history seems to repeat is that no one can use history to predict the future.

ANYTHING CAN HAPPEN

December 16, 1993

Early this year, I thought inflation might indeed be on the way back. . . . So far, that possibility hasn't been realized.

I don't believe — as many seem to — that gold prices forecast inflation rates. That would require gold investors to possess some special ability to foresee inflation — a special gift denied to the rest of humanity. . . . Gold has made its spectacular gains only by moving <u>with</u> inflation or just behind it. When gold tries to blaze the trail itself, it doesn't get very far.

Of course, for all I know, inflation may well come back with a vengeance a year or two from now. Certainly President Clinton — a caring, compassionate man — is doing everything he can to aid those of us who might like to see gold stage a comeback.

Budget deficits sure to rise over the rainbow, taxes as high as an elephant's eye — these are not the ingredients of a healthy economy. And we have to wonder whether, somewhere down the line, Alan Greenspan will get religion and decide that fighting inflation isn't as important as getting the economy moving again.

But if you're trying to decide where the economy and the investment markets will be going the next few years, my advice to you is: <u>don't</u>. Don't try to figure it out. Don't think that there's anything the Clinton program has made inevitable.

The government battered the economy during the 1960s — with new federal programs, new paper money, and new controls. But the economy withstood it quite well — and both GNP and the stock market soared to higher and higher levels.

Of course, the reckoning arrived — but not until the 1970s. And that's the point. If this were, say, 1965, you couldn't help but believe the economy and the markets were about to take a terrible dive. They did, but not before many years passed.

The same may happen again. The Clinton program may, in fact, help parts of the economy that are quite visible — while other sectors suffer in the shadows. There may even be enough apparent prosperity to get Mr. Clinton reelected in 1996.

That prosperity might keep the stock market chugging along for another few years. It might dampen inflationary expectations. And it might even keep interest rates relatively low. "Bankruptcy 1995" may go the way of "The Depression of 1990" — which is to say nowhere.

I'm not saying any of this will happen. I'm saying only that anything can happen — and that the investment markets seem to take sadistic delight in punishing those who believe they're smarter and more perceptive than the rest of us.

Predicting the Future

Even in the early days of the newsletter, I was wary of predictions (although not wary enough to avoid them entirely). But the realization that it is impossible to predict human action — and especially impossible to predict events that will depend upon the actions of millions of humans — grew steadily during the first 10 years of the newsletter, until I became a complete agnostic about the future.

SEEING ALL THE POSSIBILITIES

September 15, 1975

No one can predict the future precisely. Even where fundamental factors indicate specific trends, the timing of those trends can't be specified; it can only be guessed at.

It is important for an investment advisor to state <u>all</u> the possibilities he can see. There are always risks — most importantly, the risk that the advisor is wrong. So the advisor should always inform his customer of the risks involved — because <u>the risks may be more than the client should bear</u>. And it is always the client who does bear them. . . .

My work is designed to aid the investor who does not want to spend all his time watching his investments — or watching his investor advisor. I offer long-term alternatives — mainly for the investor who wants to make his investments and then spend his time doing other things.

FORECASTING vs. STRATEGY

March 9, 1980

We act on our expectations of the future. But to confuse expectations with certainty is the road to disaster. Humility is the realization that you don't know everything, or even everything about any particular thing, and it is an investor's most vital asset. Arrogance eventually ruins any investor — no matter how well he'd been doing.

Once you get beyond the feeling that you must be able to predict the future, you can get down to the serious business of investing in a realistic manner. Since you can't predict the future, you'll develop a strategy that allows you to deal successfully with an uncertain world — a strategy that recognizes your own weaknesses and emotions, as well as your ignorance.

PREDICTING THE GOLD PRICE

March 2, 1982

No matter how plausible a prediction may sound, attempts to guess the future are both unrealistic and unnecessary. There are more factors affecting an outcome than anyone could hope to consider. Predictions are only parlor games — a form of entertainment. They aren't tools for making investment profits. . . .

Whether based on fundamental or technical analysis, predictions and forecasts can have a plausible ring to them. They can seem to be based on considerations of the real world. Unfortunately, the human mind doesn't have the ability to recall the plausibility of earlier predictions that didn't work out.

For example, way back in 1980, it was explained to us that central banks would buy enough gold at $600 to prevent the price from going lower, because they wanted to protect the value of their large gold holdings. By citing this now, I'm admittedly beating a very dead horse; but it doesn't hurt to remember this whenever we're given a plausible reason that gold can't go below $400 or $350 or $200 . . . or $35.[1]

We were told that the South African and Soviet governments would reduce their sales to the market, if necessary, to keep the gold price from dropping too far. Before that, we were told the U.S. government would sell enough gold to keep the price from going too high. Neither forecast was redeemed by the future. . . .

A "better than average track record" in predictions is of no help, because one bad forecast can more than offset a lot of gains.

For example, many people were so impressed with the ability of one forecaster or another to predict higher prices for silver during the 1970s that they refrained from selling at $30, $40, or $50 — when those same forecasters raised their predictions for the top to $100 or higher. Many of those investors bought at prices considerably higher

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[1] Amazingly, a London gold dealer just resurrected that argument to explain why gold wouldn't go below $350.

than today’s. For them, one successful and one unsuccessful prediction have combined to create large net losses. . . .

As in Life

Forecasting schemes can be very compelling, because they seem to offer a system that will beat the world. The great white hope always is that there’s a way to get ahead of everyone else.

This hope isn’t limited to the investment world; it permeates all areas of life. People look to ESP, utilitarian religions, reincarnation, astrology, Elliott Wave, computer investment systems, numerology, Biblical prophecy, and dozens of other doctrines to get an edge. These ideas can be interesting and entertaining to explore, but they can’t help us to predict the future or guide our actions successfully.

Eventually, we have to return to the real world — to what we can perceive with our five physical senses. And we need to develop a philosophy (or investment strategy) to use what we see — a strategy that’s consistent with what we know about human action. Any other ideas and systems belong to another world — they aren’t likely to help us in this one.

Investment markets are ruled by the same human actions that affect the rest of our lives. We can’t expect mysterious rules that make no sense elsewhere to prevail in the investment markets.

In other areas, you act on assumptions and expectations. But you’re ready to alter your assumptions as new evidence becomes available. You can do this because you don’t confuse expectations with facts, and because you have a philosophy that can guide you through an uncertain world. Your philosophy allows you to profit from your assumptions, as well as abandon them cheaply when they prove to be wrong.

But a prediction implies a certainty, a precision, that doesn't exist in the real world. It encourages you to place a bet that can pay off only if the prediction turns out to be correct. Such betting is no wiser in the investment world than it would be elsewhere.

The strange thing is that most people aren't concerned with predictions in other areas of life. One sets goals, rather than predictions, for his income, personal relationships, and living conditions — and tries to satisfy his goals. But only a foolish individual places bets on the future — such as making a purchase based on a prediction of a higher income that will pay for it.

And yet, when one enters the investment markets, the first thing he does is to look for a fortune-teller, someone who can predict next year's gold price. In other areas, the fortune-teller is an object of amusement. But nine out of ten economists and investment advisors attempt to make their reputations as soothsayers — and nine out of ten investors spend their lives trying to find the soothsayer who's genuine.

They never seem to learn that the fortune-teller with the perfect record up to now will go sour the moment you start acting on his predictions.

"Insiders" are of no more help than seers. In 1970, the chief gold trader at a large Swiss bank told a friend of mine that the gold price would never go above $40. When asked how he could be so sure, the trader replied, "Because we control the market."

FORECASTERS SHOULD BE FABULOUSLY WEALTHY

January 27, 1994

[Forecasters] intend that we should take their predictions very seriously. In doing so, they try to promote an assumption that's unrealistic. They would like us to believe that there are degrees of success in forecasting. They use expressions such as "Of course, no one has a perfect record" or "We all have our good calls and bad calls." We are meant to believe that forecasting may produce more or less benefits.

But that isn't really true. And if you stop and think clearly on the matter, you realize that there's something not quite right about the way the case for forecasting is presented. You either can make money forecasting or you can't. As with pregnancy, there are no shades of gray. The question is: "Can you make a profit forecasting the future or can't you?" If the answer is no, I don't want anything to do with your predictions. If the answer is yes, we have some business to discuss.

If you can forecast the future, then you should be rich — very, very rich. I don't mean that you've accumulated a paltry million dollars or so. I mean you must have a quarter billion, $2 billion, $5 billion, or more.

Why wouldn't you? If you can reliably forecast the investment markets, you should be able to make profits of at least 50% a year — if not 100% or more. If you could produce even 20% a year reliably, you would be the most wanted investment advisor in the world. It wouldn't matter if you didn't have a penny to begin with; there are people out there with plenty of money — Bank of America, George Soros, Goldman Sachs, and hundreds more — who would gladly stake $100 million or more on your genius. And after you'd accumulated a few million for yourself, you could kiss them goodbye and keep 100% of your future forecasting profits.

Almost every investment advisor claims to have a profitable forecasting record. But why, then, isn't Rupert Murdoch or Fidelity Funds beating down his door with offers? He may say that they don't know about his talents. But why not? They have good reason to seek out someone so talented, wherever he is.

Or he may say that they refuse to believe he can do what he says. But if he can't prove to them that he can forecast the future profitably, why should we believe him? There's nothing vague about investment trades: every buy or sell order has an established price and identifiable transaction costs. So there's nothing gray about the outcome: either the forecaster makes money on his forecasts or he doesn't. If he's successful doing it, he can prove it to anyone.

Of course, if all he does is toss off a number of predictions and then revisit a handful of them a year or two later, we're not talking about the real world or real money. We're simply playing a parlor game — Master of the Universe for would-be investors. In that case, he should play the game and have fun, but he shouldn't ask us to pay attention to him or allow him to make our investment decisions.

IS THE END NIGH?

November 20, 1996

We could review all the warning signs that this bull market is running on borrowed time. But what good would it do? We could have done the same thing a few years back when the Dow was around 3,000, but time has proven that the warning signs were only curiosities.

The Benefits of a Permanent Portfolio

Over the past 15 years readers have been inundated with reasons, examples, reassurances, and badgering that only a well-balanced Permanent Portfolio would allow them to relax about their investments. Here are some of my comments.

BEING PREPARED FOR EVERYTHING

June 13, 1984

[<u>In answer to a questioner who feared that the government was going to replace the currency and that it might repudiate all its debt — making Treasury securities worthless.</u>]

It isn't that these things can never happen (the first rule of investing is that <u>anything</u> can happen), but they are no more likely than any of hundreds of other potential disasters — disasters that don't happen to engage your interest.

The answer isn't to outguess the government's intentions (you can't), but to be sure you're protected against any such eventuality by having a balanced Permanent Portfolio.

Invested 100% in Treasury securities, any sane person would lie awake nights wondering about the most remote risks to Treasury securities. But if only 20% to 30% of your portfolio is in Treasury securities, and the other investments are pointed in various other directions, you know that any losses inflicted on you by surprise currency exchanges or debt repudiations would be more than offset by gains in your gold, Swiss francs, etc.

THE 1987 STOCK MARKET CRASH

October 21, 1987

The stock market crash was a shock to the system, and it caused losses that won't be completely offset immediately. But it can't destroy you if you have a balanced portfolio.

Most investors have <u>all</u> their capital — precious and speculative — in the stock market. And, no matter how much they have made in the market over the past few years, the crash has been a terrible trauma for them. Not just because of the money lost — but because there's no way to know how much more will be lost, since they're afraid to sell and see the market rebound, and because the crash makes such a person realize just how vulnerable he is.

The Permanent Portfolio sparkles at times like these. Its most important benefit is the knowledge that you can weather these crises, and so you don't have to be afraid of what's coming next.

If you don't have a balanced, safe Permanent Portfolio, I hope the crash has prompted you to get your house in order now.

GEOGRAPHIC DIVERSIFICATION

October 21, 1987

I think geographic diversification is vital.

The Permanent Portfolio will be safe enough to walk away from and forget only if it allows for more than just the problems and hazards that are obvious today. It will have to allow for all the unforeseeable events of the next 5, 10, 15, or 20 years.

Keeping some investments outside your home country provides safe and easy protection against surprises that might happen anywhere — confiscation of gold holdings by the government, exchange controls, civil disorder, even war.

Having some of your investments outside the United States offers several benefits:

1. It will preserve those assets even if war or civil disorder should disrupt record-keeping in the U.S.

2. It will give you the time and opportunity to respond to any extraordinary policies adopted by the U.S. government. No one knows how the President or Congress elected in 1988 or 1992 might choose to solve the economic problems they'll face. Expropriating your property for some urgent public purpose might strike them as the ideal solution.

3. It will reduce what you might lose to mismanagement, a weakening of law enforcement, or a physical catastrophe in the United States.

These hazards may seem remote. And they are — in the sense that I don’t expect any of them to happen tomorrow morning. But they are real hazards, and now and then you feel the reality — when a politician urges something especially dangerous or foolish, or it’s revealed that the Internal Revenue Service has acted in a particularly heavy-handed way, or an international conflict threatens to erupt into something big.

Someday a remote hazard will grow into an immediate threat. Geographic diversification is a necessary part of making sure the Permanent Portfolio can handle whatever hazard materializes.

THE 1987 MARKET CRASH WITH A PERMANENT PORTFOLIO

December 16, 1987

On October 19, when the Dow Jones Industrial Average fell 22.6%, the 4-investment Permanent Portfolio lost only 4.3% of its value. As of December 11, the portfolio is down 6.3% from its high reached on August 14, but still up 3.9% for 1987.

The Permanent Portfolio Fund had a similar experience. It dropped 3.0% on October 19 (to $14.71 from $15.17). At $14.56 on December 11, it is down 7.8% from its high of $15.80 on August 3 — but is still up 10.5% from $13.18, at which it closed 1986.

THE 1987 MARKET CRASH WITHOUT A PERMANENT PORTFOLIO

January 17, 1988

[There is an] amazing number of newsletter writers who somehow got out before the crash.

My mail box has been flooded with solicitations from newsletters that were astute enough to have their subscribers on the right side of the market.
But The Hulbert Financial Digest, which monitors 203 model portfolios recommended by newsletters, found that 77% of them lost at least 10% for the month of October alone.

And that's just the tip of the iceberg. One newsletter that was rated #1 by Hulbert two years in a row lost 58% in just one month. You can imagine how reassured I felt when I received a solicitation from that newsletter, telling me, "Many of our subscribers were 100% in cash well before the 508 point crash of the DJIA."

Another newsletter, which through June 30 had compiled the best 7-year record of all the newsletters Hulbert has monitored, lost 57% in October. But, by contrast, the editor of that newsletter is one of a small handful of writers who have acknowledged publicly that they were on the wrong side of the market in October.

The one-month losses listed in Hulbert are something to behold — with numbers like 21%, 30%, 41%, 50%, 75%.

But many of these writers scurried around and found references in pre-crash issues to "caution" or "selectivity" or "storm clouds." Somehow these became, ex post facto, warnings to get out of the market; it's too bad if you didn't get the point.

After all, 21%, 30%, and so on are just numbers. The important thing is to preserve one's reputation as a market genius. Who cares if "50%" happens to represent half the $40,000 life savings of someone in Iowa? Or if "65%" represents most of the capital that produces the yearly income for a retired couple in Oregon?

Some market timers did manage to get out before the crash, which is certainly to their credit. But newsletter writers are, by nature, exaggerators; we can't seem to leave well enough alone.

So a writer who did get out ahead of the crash isn't satisfied saying simply, "I told people to sell in September." He has to elevate this to "I predicted the crash" — when, in fact, he said nothing in advance about a crash. And in some cases, such a person explicitly forecast a market correction of a size that, taken literally, would have meant the correction was already over before October 19.

And if you think the market timers who were right in October are the ones to heed the next time, you're asking for trouble. As Richard Russell said, ". . . some guru who's been right as rain on the market for an extended spell. . . can be dead wrong" the next time.[1]

As I've said too often, the advisor with a perfect record up to now will lose his touch the moment you start acting on his advice.

Mr. Right is no substitute for a Permanent Portfolio.

PREPARED FOR ANYTHING

February 20, 1991

Understanding what the politicians are doing now should help you realize what they're capable of doing in the future — which is almost anything. The inconsistent statements; the phony, shifting motives; the aggressiveness; the willingness to sacrifice other people for a New World Order — all these things should remind us that governments are capable of anything, that nothing about the government is stable, reasonable, predictable.

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1 Dow Theory Letters, December 30, 1987, page 4; P.O. Box 1759 La Jolla, Calif. 92038; 26 letters per year, $225; sample issue, $1.

Politicians will do almost anything they think they can get away with if they believe it will advance their interests. And what they can get away with varies as times change. As the public mood shifts, what would have been an outrage one day can become acceptable and undebatable the next. . . .

Never deceive yourself by thinking you understand the political mind so well that you know what they'll do next. Politicians are unpredictable.

Don't waste your time with questions such as "Are they likely to impose exchange controls?" or "Would they be willing to let Citibank fail?" or "Will they issue a new money?" or whether they'd risk a public outcry by imposing some unthinkable policy.

They're likely to do anything.

And so <u>you must be protected against everything</u>.

If your investment program doesn't allow for that kind of uncertainty and anarchy, it isn't protecting you. If your strategy demands that you anticipate their next move, it's only a matter of time until you suffer an unbearable loss. . . .

An investment program that fails to allow for every contingency is only a speculation.

WHEN/HOW WILL THE BULL MARKET END?

February 28, 1997

There's nothing I can say to shed any light on the potential duration of the bull market — nothing I haven't said many times before. It will end when it ends, and there's no way we can foresee it — not by examining the economy, not by pouring over charts, not by looking at ratios of one thing to another, and not by investigating historical patterns.

Not only that, but we don't know <u>how</u> it will end. Will it come with a bang or a whimper? Will there be an enormous crash, in the style of 1929 or 1987 — or will there be a long, slow, steady descent — as happened in 1973-1974? We don't know. And anyone who claims to know is just having a good time at your expense — and maybe his own as well.

What should you do? Just make sure precious capital isn't vulnerable to a stock-market collapse. If you have less than 35% of your Permanent Portfolio in the stock market, nothing that happens there can destroy you. If you have 50% in the market, a sudden crash might force you to make drastic changes in your retirement plans.

Learning from the Hard-Money Era

In early 1980 it became apparent that the risk-reward ratio had been altered considerably. Gold at $600-800 was no longer the safe investment it had been at $35 — or even $100. Silver at $30-50 was not the same investment it had been at $3, $5, or even $10.

By this time I was fully aware that neither I nor anyone else could predict how high these prices would go. But it was unlikely that either gold or silver would go so high that it was worth risking the destruction of the tremendous profits we'd accumulated.

In January 1980 Terry Coxon asked me whether I was going to suggest that people sell their silver holdings. As I recall, I asked him, "Why would I do that?" — but by the time the words were out of my mouth, the answer was obvious to me. So, with silver fluctuating between $35 and $40, I wrote a 5-page article reviewing the history of silver, and pointing out that it was no longer worth holding.

I’ll always be grateful to him for calling my attention to the obvious.

Meanwhile, I worried that our readers would be overextended and unable to cope with the inevitable fall that would accompany the end of the hard-money bull market — since this was before the days of a well-balanced Permanent Portfolio. And my feelings of that time should be just as appropriate today for investors who have bet their all either that today’s bull market in stocks will last forever or that they’ll know how to get out before the inevitable fall.

As you read some of the early excerpts, translate the references to precious metals in 1981 into stocks in 1997. One of my proudest accomplishments as an investment writer was in helping people recognize when the hard-money era ended. I hope that today I have kept some people from throwing everything into the stock market.

FAREWELL TO SILVER

January 23, 1980

The extraordinary promise of silver ten years ago was based upon three factors: (1) nearly 100 years of U.S. government price controls; (2) the inelasticity of industrial demand; and (3) the inelasticity of production. The combination of these factors created a once-in-a-lifetime opportunity. . . .

In my books, I’ve maintained that the [supply-demand] deficit will be eliminated when the silver price is high enough to cause enough industrial consumers of silver to abandon the use of it. And I’ve said that we probably couldn’t know what price that would be until after the fact, but that it would be enough above $5 to make silver a worthwhile investment.

The reason for the uncommonly large price increase would be the inelasticity of demand. In most industrial applications of silver (silverware is the main exception), the amount of silver used in the end-product is very small, although critical to the success of the product. Thus, an increase in the silver price would not significantly affect the manufacturer’s cost — while abandoning silver would significantly affect the value of the product.

These fundamentals, as stated several years ago, were discoverable, logical, and very promising. The problem today is that many people will attempt to apply them to $40 silver in the way they applied to $1.29 or $5 silver. . . .

No one can know for sure what the equilibrium price for silver will have to be. But at least we can know that a demand that was inelastic at a price of $1.29 doesn’t have to remain inelastic at a price 31 times higher. . . .

The premise for including silver in the Permanent Portfolio was an expectation that, over a period of a few years, the price would probably rise by 200% or more.

While there might be other investments with large potentials, silver had the advantage of being a physical commodity that could be stored in a Swiss bank (or elsewhere) — immune to government intervention, market closings, chaos, defaults, etc. It was an ideal component in a Permanent Portfolio.

While silver still has the latter advantages, it no longer has the overwhelming potential for price appreciation that it had at $5 or less. I can’t tell you that it won’t go to $100 (or more) eventually. But there was far, far more reason to expect $15 when it was at $5 than there is today to expect it to go to $100. It is no longer an investment that is clearly underpriced. . . .

At $40 per ounce, silver has more than satisfied its reason for being in the portfolio. What is surprising about the situation is that the price achieved was so high and that it happened so quickly. I had expected to hold silver for several more years — and I hadn’t dreamed the price would be so high even then. . . .

I suppose that, no matter how I put the case, someone may say I’ve lost faith in silver. But how could I lose faith in something that’s been so good to me? I will always be grateful to Jerome Smith for bringing silver to my attention in 1967 (and, incidentally, luring me into the investment business.)

Silver has done everything that was expected of it — and more — and now its run is ending.

We can’t always live in the future. Sometimes the future arrives. Many of us have lived a long time with silver’s future, and it’s hard to realize that the “future” is now the past. . . .

Ah silver, you’ve been so good to us. Now that you’re retiring, I wish you had a son who could take your place in the business.

HARD-MONEY INVESTMENTS — THE WAVE OF THE PAST

March 18, 1981

The heyday of hard-money investments is over. What’s left is only the inevitable aftermath, the time when what was once avant-garde becomes commonplace — and therefore worthless. . . .

Consider these lines from a book published in 1980:

> There are two secrets to financial success in inflationary periods. They are:
>
> (1) Buy equity — things that will go up in value as the dollar loses its purchasing power.
>
> (2) Use borrowed money.

The author goes on to point out that by equities he means such things as "real estate, commodities, gold and other precious metals, some stocks, art and antiques, wine, old stamps, books and rugs, memorabilia."[6]

Is this an isolated piece of advice from someone who is privy to the wisdom of the insiders? Hardly. I heard much the same thing stated over and over again to 4,000 people at the New Orleans Gold Conference last November.

On the New York Times best-seller list of March 1, the #3 book was Douglas Casey's Crisis Investing, in its 26th week on the list — including a few weeks in first place. Jerome Smith's The Coming Currency Collapse was #8, in its 12th week on the list. Both books are dominated by hard-money advice. In 13th place, after 39 weeks on the list, was Robert G. Allen's Nothing Down — a book that tells you how to speculate in real estate with borrowed money. And in 15th place was Venita VanCaspel's Money Dynamics for the 1980s — a book I assume is sympathetic to hard-money investments. (I haven't read it but I'm acquainted with the author.)

These four best-sellers are only the icing on the cake. Many book stores prominently display a table of "inflation beaters" — books with "alternative" approaches to investment. There are literally dozens of such books — including one called America's Coming Nightmare Inflation, Economic Collapse & Crime Revolution. . . .[4]

The daring, adventurous, stand-alone investment policies of the 1970s have become the trite, cocktail-party clichés of the 1980s.
When I first started accumulating silver coins and gold coins, I had to go into the back of a liquor store to find Louis Carabini's Pacific

[6] How to Invest Your Money & Profit from Inflation by Morton Shulman, Random House, N.Y.; pages 29-30.

[4] This is not a joke. It was advertised in Barron's, March 9, page 37. Next month we may find an investment book with "Tarantula Invasion" in the title._

Coast Coin Exchange — the forerunner of the billion-dollar Monex International. Today you can buy gold bullion at Citibank, Republic National Bank, Morgan Guaranty Trust, and other big banks. You can buy gold or silver certificates at First National Bank of Chicago and many other places. You can even get gold passbook accounts(!) at First National Bank of Chicago and Deak National Bank.

The "establishment" newspapers are overrun with articles on gold, silver, currencies, collectibles, you name it. In the next few weeks, <u>People</u> magazine will publish an interview with myself and two other hard-money advisors. <u>People</u> magazine, for God's sake!

And for one last example, in the new movie <u>Why Would I Lie?</u> a young man about to inherit $300,000 says he's going to invest it in silver, and cites the world's silver shortage as the reason for his plan. . . .

Some of us started buying hard-money investments as long ago as 1967 (or before). We didn't expect their prices to shoot upward the next day; we knew it could be several years before they took off. As it turned out, the upward moves didn't start until 1970 for gold, 1971 for silver, and 1973 for the Swiss franc. And after rising to $5 from $1.29, silver sat still from 1974 to 1978.

Waiting was an unavoidable part of the investments. Even after the prices took off, we knew we might have to wait several more years before our objectives were reached.

When the day arrived, the profits more than compensated for the wait. But waiting had become a habit, a way of life; we were geared to living in the future. It wasn't easy to realize that the future had become the present.

Worse yet, the future became the past — and hard-money investors continued to live in what they believed was the future, although it was now the past. Dreams of price explosions are not anticipations anymore; they are nostalgia. . . .

It isn't easy to know when to sell. You can buy an investment at $5, sell it at $20 for a 300% profit, and then see it go to $50. You may spend the rest of your life kicking yourself because you didn't wait until $50 — as if you would have had greater perception at $50 than you had at $20. . . .[7]

Investing, Investments, & Advisors

I have not been easy on investment advisors. I have criticized them for claiming successes they didn't achieve — thereby luring investors into believing they could be safe just by following the advisor with the perfect record.

Over and over I have tried to wean investors away from reliance on the expectations of an investor advisor — whether that advisor was I or someone else.

LOOKING DOWN OUR NOSES

May 16, 1983

Part of the fun of investing, both for the investors themselves and for their advisors, is being able to pretend that one is so much smarter than the other players in the market.

Investment writing is saturated with remarks about the dumb sheep who can't seem to recognize facts that are obvious to the writer and

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[7] My 6-year association with Terry Coxon has helped me to keep hard-money investments in perspective, and had a lot to do with my suggestions to sell the Swiss franc in 1978 and the Permanent Portfolio silver in 1980.

the reader. The implication is that the writer and the reader are part of an elite — the chosen few — who understand the secrets of economics and investing, secrets that are unavailable to the ordinary investor. . . .

Unfortunately, reality isn't quite so accommodating. In the real world, investing is never easy. There are no dumb sheep just waiting for you to fleece them. Other people know there's such a thing as inflation; other people are astute enough to distrust politicians; other people are capable of being right or being wrong. . . .

In March 1980, when silver had fallen to $30 from $50, I listened as a well-known hard-money advisor explained to an audience that the silver bull market couldn't be over because the public was selling its silver heirlooms — and the public is always on the wrong side.

It may have been fun to look down our noses at the public who had just then discovered silver. But today there are a lot of long-term silver owners who wish they'd followed the dumb herd and sold at $30 — rather than following the expert and riding the price down to $5.

It may be fun to make up aphorisms about the ignorance and emotions of the investing public. But the successful investor can't afford to get carried away thinking about other people's "fear and greed." He's too busy watching his own emotions — trying as best he can to overcome his own pride, wishful thinking, and fear of missing bandwagons.

SYSTEMS & INDICATORS

July 15, 1987

In your investment career, you'll come across dozens — or hundreds — of infallible indicators, proven systems, and virtually riskless investments. Tomorrow someone might offer you an amazing discovery that represents a breakthrough to profit and safety. Or maybe someone will offer you a perpetual-motion machine.

Systems and indicators assume an essentially static world — in which all movement is merely a deviation from, or a return to, norms that remain the same year after year, even century after century. But in fact we live in a world in which the underlying causes of prices — technology, human wants, and existing resources — change constantly.

Thus no track record, covering the past, can tell you what works today; no indicator can foretell market movements; no system can take the uncertainty out of investing; and no investment can truly promise a profit without threatening a loss. . . .

The first rule of trading systems is:

> The system that has worked perfectly up to now will go wrong when you stake your money on it.

WHAT YOUR BROKER DOES WITH HIS MONEY

December 1, 1991

Q. On the Front Page for issue 143 [Page 143-8] you discussed the scandal in which Japanese stock brokers reimbursed large clients for their trading losses.

As you pointed out, the practice of reimbursing clients for losses isn't inherently evil or imprudent. Clients with large accounts may be prized and the income generated substantial.

However, such practices affect other clients. I suspect that fees are raised and numerous accounting tricks are employed to make it all possible with the least disruption. I wonder if it is ever stated on an annual report or in some other public document that clients were paid for losses. Not likely.

If such information were made freely available, then investors could decide for themselves whether they were being treated right by the firm.

A? Everything you need to know in this regard is given to you in one message — the price the firm charges you for its services. If the price is right, what difference does it make what the firm does with the money you pay it? And if the price is too high, it doesn’t matter how ”fair” and equitable the firm is trying to be with you. Worrying about a firm’s relationships with other people is a waste of time. If it leads to anything, it is to resentment or envy — which are even greater wastes of time.

WHAT MAKES A COLLECTIBLE VALUABLE

March 29, 1992

Q. I am seeing a lot of ads these days for “collectibles.” These include everything from new editions of coins to baseball cards. I know you’ve written that you don’t care much for collectibles, and I also am skeptical of anything so popular.

Still, it appears that many items produced a few decades ago now command amazing prices — such things as dolls, matchbooks, and campaign buttons. And it’s hard not to get caught up in the desire to find something today that will be worth a lot 10 or 20 years from now.

I notice that some of the items being produced today are limited to very small editions. Does the limited supply increase the chance that they will become valuable someday?

A? It increases the chance from non-existent to very tiny. There is one characteristic common to all the collectibles commanding high

> prices today: none of them was produced originally as a "collectible." The dolls, campaign buttons, books, coins, and silver plate all were produced for use and enjoyment — not as investments.

I know of nothing born as a "collectible" that ever grew in market value. Any exceptions must be rare indeed.

The sought-after treasure of the year 2010 isn't being advertised today as a collectible. It is hidden among the crowd of plain merchandise that surrounds you. It might be a ball-point pen or a pizza delivery box.

If you get the impression from this that planning for success in tomorrow's collectibles market is a little like playing the lottery, you're beginning to get the point. The winners will be the dealers and a handful of lucky consumers. Foresight has little to do with it.

But if you're determined to try to spot the valuable collectible of 2010, I suggest that you focus on long-standing or popular products that are being discontinued. Among them, pay special attention to those you've found particularly charming — products you'll miss a little.

COMPETING WITH EXPERTS

October 9, 1995

I've reminded you before, but you can't be reminded often enough: the experts have nothing on you. There's no one in this world you can count on to get you into and out of investment markets with profitable timing.

More confirmation of that has arrived in the form of a finding by Managed Account Reports that only 27 of the 432 hedge funds tracked by the firm were able to match the return provided by the S&P Index.

"Hedge funds" are more versatile than most mutual funds. They go long or short, and they invest in any kind of market that currently looks promising. We're always hearing about folks in these funds making enormous profits from being in the right place at the right time — whether by buying bonds just before the Fed loosens up or by selling currencies short and supposedly driving exchange rates down.

They usually charge fairly large fees as well — 1% or 2% per year of the assets plus maybe 20% of the profits, even if the profits aren't as large as you would get in a Permanent Portfolio or from investing in a stock index.[4]

So don't be impressed by big fees or breathtaking press reports. These people don't know much more than you do.

INVESTING & SPECULATING

December 17, 1995

As I've pointed out frequently, there's a difference between investing and speculating.

Investing allows you to increase your wealth by earning the return the investment markets offer to everyone. Over the very long term, that's likely to be around 4% to 5% per year after adjusting for inflation. Through careful, conservative investing, you can protect and enhance the wealth you create in your business or profession.

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[4] I'm indebted to "Gekko" of National Review (August 14, 1995, page 26) for this information.

Speculating is an attempt to beat that return — by putting your money in the right investment markets at the right time, or by picking individual stocks that outpace the market as a whole. Speculation is for the impatient — those who hope to amass wealth quickly. Forecasts and trading systems are its tools. But speculation seldom changes anyone’s life materially — except by bringing catastrophic losses.

That isn’t to say no one has ever made a fortune speculating. Some of us made small or large fortunes during the 1970s. And there are people who have managed to stay on the right side of the markets through most of a long speculating career.

But the latter are a rare breed. They are people who have a unique intuitive feel for the markets. And some of them are just lucky: it’s not unreasonable to expect one out of every 10,000 speculators to compile an amazing record.

Depending on the Financial Press

So much of what we take for granted about investments comes from something we’ve read in the financial press. But business writers are just as biased, and no more accurate, than political reporters. I have written a great deal about the misinformation that passes for investment information. Here are a few examples.

EXPLAINING PRICE MOVEMENTS

November 1, 1991

The turnaround [in the currency markets] on Tuesday, October 29, points up how little anyone knows of the reasons for day-today price movements — even large movements.

On Monday, the [Swiss] franc fell 0.85¢ — an unusually large one-day drop — to $.6633. According to press reports, traders expected a forthcoming GNP report (due to be released the next day) to indicate that the U.S. recession had ended. And, in fact, the report turned out as expected, showing that GNP had grown at an annual rate of 2.4%.[4]

What could be better for the dollar? What could be more bearish for the foreign currencies? And yet the dollar plunged on Tuesday with the franc rising an enormous 1.35¢. Why?

Who knows? The explanation reported by the press was: yes, the recession appears to be over, but now traders fear that the rebound may be brief and that a second dip might follow.

Of course, that possibility had been just as real on Monday as on Tuesday. So why wasn't the franc strong on Monday?

Again, who knows? In fact, 90% of the time no one knows why any investment market goes up or down on a given day. Sometimes the explanation offered seems to make sense. But the plausibility evaporates when you remember that, on some other day, the same supposed cause was accompanied by the opposite result.

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4 The rise of 2.4% means the U.S. Gross National Product was estimated to have risen roughly 0.6% during the July-September quarter – which would imply a gain of 2.4% if growth continued at the same rate for an entire year. Any GNP figure reported states an annual rate of increase, and includes an adjustment for inflation, so that the result is an estimate of the real growth in the economy.

Reporters have to report not only what the market did but why. But they usually don't know why, so they make up an explanation or borrow one from any trader who's in a talkative mood.

ECONOMIC ILLITERACY

July 20, 1994

So much of the alleged data on which we might base short-term investment decisions comes from alleged business and financial reporters who really are just cheerleaders for a political program.

Not only do the writers slant economic reporting to accommodate their political beliefs, it's doubtful that many business reporters even know or care what the truth is, how the economy works, how companies succeed, how people earn money in the investment markets, or how government programs affect investments.

Someday take the time to read every news article in one issue of The Wall Street Journal. Compare the description of the business world you see there with your own experience. You may wonder in what world the reporters live.

A stunning example of their viewpoint appeared on the front page of the July 18th Journal in the article "Microsoft Will Remain Dominant Despite Pact in Antitrust Dispute" by G. Pascal Zachary. The article appeared in conjunction with the recent settlement of the U.S. government's investigation of Microsoft — the world's largest computer software maker.

The writer discussed Microsoft's success at great length — and offered as reasons for that success the hardball tactics of its founder Bill Gates, its privileged position as maker of both operating-system software and application software, the pressure it puts on computer-makers to include DOS and Windows with their computers, deceptive publicity, hiding secret computer code within the operating system to gain an edge over rival software makers, bundling its programs into "suites" so that smaller companies can't compete, and so on. Apparently, the writer learned all he knows about business from Harold Robbins and Oliver Stone.

In the entire long article, there wasn't a single reference to the quality of Microsoft products, the company's service policies, or levels of customer satisfaction. The writer apparently has never heard that consumers pay for products only when they believe they're getting value. Every Microsoft product has strong competition — from Lotus, Word Perfect, IBM, Borland, or someone else — and all the hardball tactics in the world can't force computer users to choose Microsoft over those alternatives.

Every business writer should have a plaque on his desk that reads:

> Companies succeed by providing what customers need and want at a price they're willing to pay.

Someone writing a story about a successful company should begin by asking: What is the company providing that consumers are so willing to pay for? If the Journal writer had approached his article this way, he might have identified some of the things that have drawn millions of customers to Microsoft — such as extremely informative user manuals, the development of drag-and-drop editing in word processing and spreadsheets, and programs that combine easy access for new users and enormous power for more experienced users.

The writer missed the most newsworthy aspect of Microsoft's success: its amazing ability to respond to consumer demand even after becoming a giant — avoiding the bureaucratic lethargy that almost destroyed IBM. Bill Gates' genius is in recognizing that the consumer is always king, and in providing an exciting "small company" atmosphere to attract the world's most talented software designers.

The Journal article typified the outlook of most people in the financial press. Business writers have very little idea how the real world operates. And we rely on these people for the latest economic news.

All I Know Is What I Read . . .

Are the deficits falling? Has the 1993 "deficit-reduction" program brought us a new era of lower interest rates? Is the economy growing stronger?

Most of what we know about these matters is taken from government press releases that are parroted without criticism by willing business reporters.

How much of it is true? It's hard to know. Even those who write the stories don't know — and, in many cases, may not care.

In some matters — such as the trend in interest rates — a simple graph can tell us all we need to know. In others — such as where the deficit is going — we have to ignore what's being said and wait a year or two for the results. And in still others — such as the state of the economy — there is no clear answer, only conflicting indicators. Not only is the future uncertain, we often don't know what's happening in the present.

This is one more reason you need a Permanent Portfolio to hold the capital that's precious to you. Whatever the present leads to, you'll be taken care of.

Writing a Newsletter

Here are some items having to do with writing a newsletter — how it affects one's investment perspective and such.

REEXAMINING MY IDEAS

July 20, 1994

From time to time, we review our editorial format — trying to make it more satisfying for you and more marketable for us. Your suggestions are always welcome, by the way.

One piece of advice I’ve received is unassailable: each newsletter issue should be a fast read — with short coverage of many points, rather than an in-depth look at a few items. This, after all, is what distinguishes newsletters from magazines and books, which cover topics in more detail.

Of course, this newsletter is just the opposite of the ideal. I can’t clear my throat without explaining all the details to you. I can’t imagine throwing dozens of facts, tips, and conclusions at you without giving the supporting evidence and analysis. There are two reasons for this:

- I like to believe our readers are too intelligent to act on some suggestion just because I made it.
- Until I actually write out an explanation for my conclusions, I can’t be sure they’re correct. So why shouldn’t you see the reasoning process as well?

The first point — that this letter appeals to well-functioning intellects — may be just my conceit. But the second point is unshakable. There’s no question that writing an explanation makes my own thinking firmer, cleaner, and more precise.

At least once a year, I find myself abandoning an opinion after trying to write out the reasons to support it. Sometimes I change my mind when I gather the data to buttress an argument and find that the data won’t support my belief. Other times, as I set down the reasoning — that step 1 leads to step 2 to step 3 and so on — I discover that step 2 doesn’t lead to step 3 after all, that there might not even be a step 3. And, as a result, I see the subject in a whole new way.

NEGATIVISM

May 17, 1995

It may seem sometimes that my comments on the markets are 90% negative.

Actually, it’s only 89%.

I do write a great many negative comments on the hopes and dreams of advisors and speculators. This isn’t because I’m a constant bear or a curmudgeon — but only, I hope, because I’m a realist.

My negativism isn’t a statement that a given market can’t rise — only that the arguments being advanced for the inevitability of a rise are mostly wishes. My purpose isn’t to keep you out of speculations — only to keep you from over-speculating on the advice of exuberant bulls.

People do make money in investments. But most of it comes from long-term, buy-and-hold positions — especially long-term positions in U.S. common stocks. It seems almost certain that the average in-and-out trader does worse than he would by just sitting still.

If he doesn’t go bankrupt — or if he even gains over the years — it’s because he also has a number of investments he rarely trades. Those might be holdings tucked away in a company pension plan, his own pension plan, or an annuity — or they may even be normal investments that he’s smart enough not to play around with. But his speculating most likely is an expensive hobby. . . .

It always comes back to this:

- Your career is the source of the wealth you amass.

- Your investments help to secure and enhance that wealth.
- Your speculations are for entertainment.

If you don't find speculation entertaining, you shouldn't have anything to do with it.

Fan Mail

From the beginning of the newsletter, it was an unwritten policy not to publish complimentary letters (perhaps because I'd seen too many of those flaunted in other newsletters), but to publish critical letters and questions.

These showed up in the extensive Questions & Answers articles — hence the Q&A format below.

Some criticisms evoked confessions of guilt from me, others provoked arguments, still others triggered smart-aleck replies, and some were simply reprinted without comment on the complaints. Here are a few you might find interesting.

The first item is included because I think it's important to be reminded that we like, love, and respect certain people <u>because</u> they are different — so we should learn to accept those differences when they inconvenience us.

AND ANOTHER THING . . .

August 30, 1983

Q. You may be a brilliant economist, but you must translate that into help for your public. Your detached, haughty attitude comes through in your letters.

Get with it, Harry. the world is not waiting for you. Your often late, empty letters have gotten tiresome. You spend more time telling us why you had nothing to say, why you were going to be on time next time, etc. that you forgot to share what knowledge and insights you had.

A. . . . There's no doubt that I'm lazy, disorganized, obstinately against acquiring a staff that will offset my deficiencies, overly ambitious in the sense of expecting to do things that there isn't enough time for, and in many other ways the opposite of the stalwart individual that most people would turn to for investment help. And since it's taken me many, many years to accept myself as I am, I don't know why in the world you should do so.

But the simple truth is that I am different from most investment advisors. That difference led me into hard-money investments at an advantageous time, and then led me out of them at advantageous times. In other words, my differences have often been helpful. Don't expect me to be original while maintaining all the virtues of your local banker or pastor. I also don't do windows.

Your appraisal overlooked some of my more shocking qualities, but I'm going to leave well enough alone and not discuss them here.

SOUTH AFRICA STRIKES AGAIN

September 8, 1985

Q. I recently renewed my subscription, which had lapsed several years ago. I was somewhat chagrined to find that this now includes facile vilification and personal attacks undoubtedly intellectually cribbed from George Will.

> The Nobel Peace Prizes were to be "awarded for the best work in the fields of physics, chemistry, physiology and medicine, and literature and towards the promotion of international peace."
>
> The Columbia Encyclopedia (emphasis mine)

To the betterment of "your (best) knowledge" its award to Bishop Desmond Tutu of South Africa was more apropos than the award in 1906 to Teddy Roosevelt, or than the Congressional Medal of Freedom award to Frank Sinatra in 1985 by the Great Blow-hard who imitates Teddy while impersonating Frankie and Franklin.

To many minds, your definitions of authoritarian and totalitarian governments are perfect descriptions of the USA procured by the assassinations of Lincoln, McKinley, and the Liberty conceived by Jefferson, Franklin, Washington, et al. We and the rest of the world are now divided into that marvelous new device, the ToTwoToo Party System, free to choose as a LibCon Leader of the Western World a RepubliCrat, blessed by your assurances that:

> A conservative who won't let someone experiment with a new lifestyle for himself is an offensive busybody, and a liberal who's determined that we all must be forced to participate in his latest brainstorm to remake the world is a danger to anyone he can reach.

Ipsissima verba, and Amen to that.

Please spare me your exposé on the evils perpetrated by libertarians, vegetarians, and nudists. Also from those of the committee that not only designed the camel, but also wired the logic circuits of your brain. I have decided you are the Global Village Idiot, and to disinvest myself of Harry Browne’s Special Reports. Please return my money.

A? Is it something I said?

Thank You

If you found anything of value in this article it was there because your support of the newsletter made it possible. So perhaps it’s fitting to finish the article with an excerpt from one of many statements of gratitude I’ve made through the years.

HAPPY HOLIDAYS

December 19, 1983

I very much appreciate your subscribing to this newsletter — reading my outpourings of advice, joy, disgust, and intended humor. I’m enormously flattered that you want to know what I have to say. But your capital isn’t an endowment fund for my ego; it’s your life savings and it must be treated with respect.

INVESTMENT RULE #1

July 25, 1984

When looking at the morass of conflicting suggestions and strategies offered by dozens of would-be geniuses (including me), it's easy to feel that you'll never figure out what you should do in a given situation. What's worse, it can seem that you may lose your life savings if you don't choose the right answer *right now.*

At times like that, there's one suggestion I hope you will hold on to, no matter what else you may know:

When in doubt about an investment decision, it is always better to err on the side of caution.

People rarely go broke playing it safe. And people frequently go broke taking great risks or making investments about which they know very little.

I don't mean that one should never take risks. Obviously, every investment, every action – even inaction – involves some kind of risk. When to take risks, how much to risk, and how to reduce risk are subjects I've covered before and will write about again.

But whenever you're in a quandary about what to do, the answer is obvious: *play it safe*. The fact that you're in a quandary is evidence that you don't know enough about the investment or its situation to make a clear-cut judgment.

WOLVES VS. SHEEP

Over the past 15 years, we've been told over and over that we must turn to risky, unfamiliar investments and strategies as our only hope for survival. How often we heard in the 1970s that the poor sheep whose life savings were in stocks or banks would be ravaged by inflation.

But none of those poor sheep has gone broke – at least not from leaving his money in stocks or bank deposits. In fact, at most, they’ve lost only a little to inflation.

Meanwhile, many “sophisticated” investors have lost money – lots of money – buying gold at the wrong time (on “savvy” advice, of course), or buying strategic metals (“the gold of the 1980s”), or losing everything to a coin dealer who went broke while supposedly storing the investor’s Krugerrands.

Results

Hard-money investors and advisors are particularly fond of placing themselves above the dummies who are still operating by the principles of the 1950s and 1960s.

But someone who bought silver at around $2 back in 1968 (when many of the early hard-money books and newsletters first appeared) and who has dutifully held on (as instructed by most hard-money advisors) hasn’t very much to show for his sophistication. At $7.20 today, a 16-year silver investment has produced a compound average gain of only 8.3% per year.

Ironically, the Milquetoast who didn’t have the courage to reach for the moon, and who simply rolled over his Treasury bills every year, earned a compound average of 8.5% per year. He didn’t have to ride a roller coaster from $2 to $6 to $4 to $50 to $10 to $25 to $5 to $15 to $7; he just collected his interest. And he didn’t have to call his broker every day, argue with his spouse, or undergo heart massage.[1]

It's true that one could have done better with silver by buying at a different time and price – such as at the very bottom, at $1.29 in 1971, which now would show an average annual gain of 14.1%. And buying gold at $35 in 1968 would give you an annual return of 15.5% as of today. And one may have done very well by selling or reducing his precious metals at higher prices. But very few of the bold, sophisticated people did any of those things.

Further, had you bought silver at $5 in 1978, just before the big uptrend, your annual return now would be only 6.3%. Gold at $300 in 1979 would give you a annual return of 3.1%. I don't even need to mention buying silver at prices above $8 or gold at prices above $350.

Over the years, I've talked with a number of investors who had been convinced by writers and advisors that they *had* to get all their money into precious metals or some other unfamiliar investment before Armageddon – and who now have a large net loss to show for their foresight.

Meanwhile, the sucker with the bank account was getting his 5% per year. Over the past 16 years, inflation has averaged 6.0% per year. So he paid 1% a year for peace of mind. That isn't such a bad bargain.

Obviously, I'm not suggesting that you put your money in the local bank. Nor am I saying that it was wrong to invest in precious metals. I *am* saying that recent history so far doesn't confirm the oft-repeated hard-money maxim that only the bold and adventurous will survive financially. I *am* suggesting that you not join any stampedes into investments you don't understand – risking money you can't afford to lose.

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1 The T-bill result is based on the average yearly auction prices for 52-week bills from 1968 to 1983, and reported in various Federal Reserve publications. When rolling over the bills at auction, there are no commissions to consider.

It’s far better to lose an opportunity than to lose everything.

YOU & BERNARD BARUCH

We’ve been told over and over that Bernard Baruch made his fortune by having the courage to “buy when blood is flowing in the streets” – meaning to buy at the time that the future seems the darkest for the investment in question.

This little homily is always dragged out to encourage you to buy when an investment has fallen in price (such as with precious metals or real estate lately.) But there are two insurmountable difficulties associated with acting on Baruch’s sure-fire plan for success.

The first is a problem I’ve mentioned before. “Blood in the streets” is an imprecise term, to say the least. With gold, for example, the blood supposedly was flowing at $400 in 1981 (the price having dropped by more than 50%), or at $300 in 1982, or at $400 again in 1983. Only the second purchase would still be profitable today – and just barely.

The second drawback to the Baruch plan is even more important:

You aren’t Bernard Baruch.

Is it realistic to think that millions of investors are going to achieve big profits copying the supposed tricks of a man who operated 50 years ago – a man with his own unique personality, his own feelings about risk, his own intuitive genius?

Could you sing like Luciano Pavarotti just from following the rules given in a voice textbook?

Could you emulate Thomas Edison's creative success just by watching an old Mickey Rooney movie?

You can't graft onto your investment personality the adages uttered by a financial genius who apparently had an intuitive feel for when a market was about to turn around.

Whether you should act boldly when the markets are in disarray has to do with who you are and what your objectives are. It has very little to do with the exploits of *any* financial daredevil.

WHAT TO DO

If you're determined to multiply what you have several times over, you may have to risk everything. But if that isn't your goal, a far less audacious plan will do.

With everything in its proper place, there's nothing wrong with taking some chances. Once you've established a safety net for yourself, it makes sense to take a flyer when the odds seem to be weighted heavily in your favor – provided you understand the investment and the risks you're taking.

That's why I speculate with the Variable Portfolio – a fund of money I can afford to lose. But this portfolio is completely divorced from the protective Permanent Portfolio. And the division of funds between them was chosen at a quiet time when no one was shouting "Opportunity!" in my ear.

We'll take risks, and I expect that we'll make some small profits, take some small losses, and make a few big profits. If there are big profits, they won't come from flinging everything into the pot on the assumption that now is the time when we must act boldly.

Fortunately, this world doesn’t require that. You don’t have to be courageous; you don’t have to emulate the masters of finance. Try those things only if you want to.

As for those crucial moments that seem to require big investment decisions, there usually are more alternatives than are being presented to you. One, for example, is to take a smaller investment position than is being implied by the urgency of the presentation.

Most of all, know that you aren’t likely to go broke if it turns out that you were too cautious.

HOW LITTLE WE KNOW

August 22, 1984

You've probably had the experience of reading a newsletter's explanation of what is about to happen in the world. The writer presents a sensible, logical, compelling argument that something is inevitable – based on what has gone before and where we are now. His case is so plausible and rational that it's obvious he must be right.

But then you pick up another newsletter and find another preview of the inevitable – and it's exactly opposite to the forecast in the first newsletter. And the second writer's arguments are just as logical, sensible, plausible, and rational as the first writer's.

Which one are you supposed to believe?

The question could be critical. Each writer might be urging you to invest all your capital in line with his forecast. To choose wrongly could be disastrous.

So how do you decide which one of them is right? Most likely, neither will be right. Most likely, the future will be something quite different from either of the two stories you were told.

If you doubt that, simply get out issues of newsletters or financial journals you received a year ago, two years ago, or longer. Read the futures that the writers laid out for you – and notice how little of it has come to pass.

This isn't a new phenomenon. The same poor result can be found for almost any set of forecasts – for any explanations of inevitabilities – of any scenarios described at any time by almost anyone.

There are two amazing things about the investment world:

1. Things almost never turn out the way anyone expected; and

2. No one acknowledges the fact that things almost never turn out the way anyone expected.

Despite all the logic, the "proven" system, the reliance on free-market economics, the superior wisdom – the simple truth is that very little turns out as investment advisors say things will turn out.

ECONOMICS

In practice, economics doesn't have the precision of a physical science. Yet so many people, especially advisors, try to treat the art of investing as if it were an exact science. People in the investment world assume that, as in engineering, investing can rely on a tidy application of cause-and-effect relationships.

Unfortunately, that isn't the case. In the physical sciences, experiments can be conducted with every variable controlled and isolated, so that scientists can be almost positive about what makes something burn, bend, bubble, snap, swing, or stand up straight.

Generally, the variables are few enough that the physical sciences can be relied on in practical applications. That's why most airplanes actually fly and why so few microwave ovens produce ice cubes.

In economics, however, every human being is a variable. There's no way to herd them all into a laboratory where scientists can test people's reactions to every imaginable set of circumstances.

So economic principles have to be created by reasoning instead of through observable tests. Since there can be no laboratory experiments, *there's no way to prove an economic principle once and for all.*

We examine history to see if there are events that *refute* a given principle. But if no refutation is found, the principle still is only ‘good until proven otherwise.” The heretofore-unseen variable that may change the result could be lurking around the corner right now.

Even the best economist doesn’t have a mind so logical, so objective that he can be sure an economic “truth” will stand for all time (although most economists like to believe they’re sure).

And even if you could be positive that a given principle would always hold, you don’t have access to all the data (the current motivations in human beings all over the world) that would enable you to apply a given principle to a specific situation and predict the outcome with certainty.

As a result, we know very little about how the economic world works. And we know very little about the events taking place right now that will affect tomorrow’s investment prices.

FALLE SCENARIOUS

Again, if you doubt this assertion, simply get out the stories, forecasts, and schemes written two or three years ago. See how little they resemble what actually occurred.

Notice, too, that most of the presentations were well thought out. They offered plausible explanations of the state of the world. The forecasts didn’t go awry because someone shot from the hip.

Here are some of the more compelling ideas that I’ve seen during the past four years:

1. “Because of the record monetary growth of 1981, inflation will explode into double digits in 1983, taking gold to a new highs.” Everyone knows that monetary growth leads to price inflation after

a 2-year time lag, and that price inflation leads to higher gold prices. But, somehow, the schedule seems to have been upset.

2. "The U.S. dollar is grossly overpriced in the foreign exchange markets; foreigners exporting goods to the U.S. will be glutted with dollars, causing the dollar to crash soon." We've been hearing this very plausible argument since 1980. And yet the U.S. dollar has gone from strength to strength up to this very day. Apparently, there were variables at work beside the U.S. trade deficit, U.S. inflation, historical parities, and the other premises upon which the dollar obituaries were prewritten.

3-4. "Interest rates will *fall* sharply because 'real' interest rates are now at unsustainably high levels" and "Interest rates will *rise* spectacularly because of the huge federal deficits."

Somehow both interest rate forecasts failed. There hasn't been a major move – in either direction – in interest rates since 1982. Treasury bill yields have remained in a range roughly bounded by 8% and 11% for the past two years.

5. "There is a proven, documented, infallible, historical link between federal deficits and inflation." In fiscal 1981, the federal deficit set an all-time record of $78.9 billion – and has continued to grow since then. But in 1984 the price inflation rate is at a 1960s level.[1]

6. "The Federal Reserve always boosts the economy by increasing monetary growth during election years." I probably shouldn't include this one – since it's more of a superstition than an investment axiom. Nevertheless, monetary growth has been falling steadily since late 1983, and the news these days is of a slowdown in the economic boom.

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[1] The 1981 deficit figure is from the Federal Reserve Bulletin, April 1984. Previous deficits were checked for comparison in various Federal Reserve publications.

7. "It is a virtually riskless investment to buy a commodity when its price is less than the cost of production, because the low price causes production to fall - creating a shortage." Examples of recent "riskless" investments have been copper at 75 cents in 1981 and 1983 (it's now under 60 cents); sugar at 10 cents in 1981, 1982, and 1983 (it's now under 5 cents); lumber at $160 in 1983 (it's now under $140); and others.

It should be a humbling experience to look over these scenarios and others that have appeared in newsletters, financial journals, and the general press during the past few years. It should demonstrate to us how little we know about how the markets work – and how little we know of what is going on throughout the world at any time.

GREAT RECORDS

Of course, the Postal Service delivers tons of mail that disputes what I'm saying.

You've undoubtedly read promotions from investment newsletters – telling of consistent returns of 50% to 100% yearly for the past five years, investments that made 1200% in only four months, and advisors that have called every top and bottom in the silver market for the past 20 years.

If only you'd subscribed to *those* newsletters instead of the ones you take – think how rich you'd be. Somehow, it seems that you're never subscribing to the right newsletter at the right time.

But some of the newsletters you do receive may be making similar claims right now. You don't see the claims because the publishers don't send promotions to people who are already subscribers.

If you could see those promotions, you might discover that *you* were supposed to have made 50% to 100% annually over the past five years; *you* were offered an investment that gained 1200% in only four months; *you* were advised of every top and bottom in the silver market for the past 20 years.

It's important to realize that very little of what investment advisors say about their performance records has anything to do with the real world – much less with helping you to make a profit. And you should pay no attention to those claims when trying to decide how your investments will be handled.

When an advisor tells you that he told people to buy silver when it was $1.29, he's probably neglecting to tell you that he also told people to buy at $5, $10, $20, even $40 an ounce.

An advisor probably is truthful when he tells you that he called the bottom of a particular bear market. But the story might be more complete if he'd mention that he called the bottom of the same bear market 6 times before he hit the jackpot.

When an advisor says with great assurance that his infallible indicators are all positive, that we should open the door and rush into some market, it would be helpful if he mentioned that those indicators have been positive before but that his subscribers rushed through the door into an elevator shaft.

PREDICTIONS

You've undoubtedly received a number of newsletter promotions that contain "15 Startling Predictions for 1984-1985." It's a good idea to keep these. Had you done so in the past, you could now pull out the same advisor's "15 Startling Predictions for 1983" and see how few of those predictions came to pass.

I'm one of those people who's incapable of throwing anything away. I still have every newsletter issue I've received since 1970 – several file cabinets full of them. As a result, it's very easy for me to check claims against reality.

In the Front Page of issue 71 (October 5, 1983), I reprinted "10 startling predictions" an investment advisor made in mid-1981. Of the 10, there were 2 whose deadlines hadn't yet expired in 1983, while only one of the remaining 8 had proven to be correct. Since then, the deadlines for the other 2 have expired, leaving the score at 10% correct.

It's interesting that the one correct prediction was:

The Social Security system, despite President Reagan's best efforts, *will* face an increasingly desperate situation. The system will be saved, but in the only politically feasible way: by massive infusions of new paper money.

How could he have lost with that prediction? Unfortunately, he didn't do so well with more mundane matters – like the direction of the gold market.

One famous advisor always uses his January issue to deliver his predictions for the coming year. He also tells us how well he did last year (without listing those predictions as evidence). Somehow, year after year, he manages to be 87% right. Obviously, anyone who's 87% right in his forecasts understands enough about the present and the future to refute my contention that we know very little.

I happen to have several years of his forecasts in my file cabinet. And, unfortunately, when *I* check them against the results, I can't seem to find a single year when he scored even 50%.

In January of this year, he reported that his 1983 forecasts had slipped to a score of only 66% correct. But I could find only 36% right – even by giving generous interpretations to the ambiguous forecasts.

When I say that no one can predict the future and that no one really understands the markets thoroughly, I realize that there are many apparent exceptions – cases in which someone apparently made a great "call" by telling us in advance that a market was going to turn.

But when you put his triumph back into the context from whence it came – buried in a pack of equally weighted predictions – you realize that his insights wouldn't have made you rich.

THE LONG TERM

Some advisors are a bit modest about their abilities to spot short-term economic and investment trends, but claim to have been almost 100% right about long-term trends.

I recently heard an advisor give his opinion about something, adding, "But that's a short-term question, and my batting average is only about 60% on short-term matters. On long-term things, I'm 90% correct." (I'm quoting this loosely, from memory.)

I've followed this man's work fairly closely since he first started publishing. And I'm not aware of a single long-term prediction he's made since he started that has come to pass.

He has explained to us the way the economy alternates between rising inflation and recession. He's explained how common stocks and gold rotate in bull markets. He has explained how inflation moves in waves to higher highs and higher lows – with the price of gold following in similar waves. He's said many other things, but this is the heart of his long-term approach; everything else flows from that. And there's a tendency for us to accept these patterns as truth since they've recurred so many times.

Yet today we have neither rising inflation nor a recession – nor have we had either of them during the past two years. After the gold runup ended in January 1980, there was no significant bull market in stocks or gold for over two years. In fact, in only 21 months out of the past 56 months have either stocks or gold been in a bull market. The inflation rate is at a 1960s level today. And the gold price is now about where it was five years ago.

What long-term trend did the advisor foresee?

I can't read minds any better than I can predict the future. But I'm full of conjecture, and I can guess why he speaks with such assurance. He's so sure that his long-time predictions *will* come true that he's already counted them as correct.

The attention the advisor gives to forecasting is doubly unfortunate, because there's so much of value he does for his readers that doesn't require his posing as a fortune-teller.

But to believe that he understands the markets well enough to foresee what's coming is to expect from him something that's impossible for anyone to deliver.

Hard-Money Successes

It's believed today that many hard-money advisors were correctly aligned with the trends of the 1970s – proving their ability to know what's going on. Unfortunately, a lot of the legend is only romantic retrospect.

For example, when silver took off from its price-fixed level of $1.29 in 1967, doubling to $2.58 by mid-1968, not one hard-money analyst warned that it could go back to $1.29 – but that's where it was in 1971.

In 1974, the only advisors warning that gold could drop by 50% from its peak were those who'd been bearish on gold all along. Investors who had followed the bullish advisors were shocked to see 50% of the value of their investment disappear in 20 months.

And of the advisors who suggested buying silver at $2 to $5, or buying gold at $35 to $200, nearly all have squandered the value of their suggestions by telling us to hang on to the investments through thick and thin – and even telling us to buy more silver at $30 or more gold at $600.

Even buying silver at $2 in 1968 hasn't turned out to be such a grand idea – if you never sold. The return on Treasury bills has actually been better.[4]

THE PAST FOUR YEARS

Perhaps the best way to see how poorly the long term has been anticipated is to look back over the past four years. The primary economic events have been:

1. A fall in the inflation rate to 1960s levels, without a deflationary collapse.

2. A bear market for gold more than twice as long-lived as any other since gold first rose from $35 in 1968.

3. A scarcity of bull markets in anything – stocks, gold, foreign currencies, silver, bonds, commodities.

4. A U.S. dollar that has been rising continuously in foreign exchange markets.

These past four years represent the most significant change in the investment environment since stocks ended a 22-year bull market

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[4] The compound annual return for silver over the last 16 years has been 8.3%, while the average yearly 52-week Treasury bill yield has been 8.5%. Gold, however, has produced a compound yearly return of 15.5% if bought at $35 in 1968 and held until now. Both silver and gold could be held without paying current taxes, while T-bill interest would have been taxed yearly.

in 1966. If it's really possible for investment advisors to call turns in the markets, to foresee significant changes, and to prepare you for what's coming, there must be at least one who alerted us in 1980 to the strange new world that was waiting for us. Who is he?

Is there one who even listed these events among the *possibilities* that we should consider?

If so, I don't know who he is. And to be convinced that someone did foresee these events, I'd have to read all his 1980 work – not his 1984 promotional copy.

When I do reread 1980 financial literature, all I find are advisors pushing one of three dominant themes: (1) this time inflation won't pause, it's going straight up (and gold with it); or (2) we're now entering the recession phase of the monetary cycles – with inflation and gold down for a year or two while stocks are up; or (3) a deflationary collapse is just around the corner.

The actual outcome was very different from any of these three expectations.

PAST, PRESENT, & FUTURE

It isn't just the future that's unreadable. The present is only a little less mysterious.

For example, why are interest rates so high today? Because of the large federal deficits, of course. No, it's because of the fear of inflation coming back. No, no, it's because the Fed hasn't loosened the money supply sufficiently. Even explanations of what's going on right now vary radically from advisor to advisor.

And the rock-solid past is no sure thing either. Historians today are still arguing over what caused the Great Depression and the Spanish-American War.

ADVISORS & UNCERTAINTY

So don't expect investment advisors to turn economics and investing into precise sciences for you. They can't do it – no more than you can – despite the wonderful performance records you read about.

Always remember that:

The advisor with the perfect record up to now will lose his touch the moment you start acting on his advice.

Past performance is no guide to an advisor's future profitability because the performance may be fictitious, the description of it may be selective, or the advisor may not even know what he's claiming.

For one very typical example, an advisory firm recently had to downgrade severely its performance claims. The reason? Apparently, neither the owner of the firm, the advertising writer, nor even the accountant had known the correct way to compute a "compound, annual gain."

It isn't that no one has ever called a market turn, or that predictions never come true, or that most advisors lie, or that advisors never make money for their customers. Some advisors *do* have a feel for the markets. Some *do* produce more profits for their customers than others do.

But you have no way of knowing how much of what's claimed is really what happened. You have to take everything you read and hear with a grain of salt.

I react to claims of great performance records in the same way I'd react to someone telling me he's invented a way for humans to fly: maybe so, but I'm not cashing in my airline ticket.

Investment advisors can't provide an escape from uncertainty.

SYSTEMS

Neither can trading systems.

Trading systems and indicators are intended to get you into and out of a market with perfect timing. And all systems have wonderful performance records.

Unfortunately, we run into the same problem here that occurs with advisors:

The system that has worked perfectly up to now will stop being effective as soon as you start using it.

I can think of two reasons for this.

One is that a system's promoter wants so much to believe in his system that he overlooks or forgets all its failures. He's like the person who believes he's able to heal himself of any sickness by applying his own mental power; he simply forgets all the days he spent lying in bed.

The other reason stems from the way that indicators are discovered. When you read of a "consistent, infallible" indicator that has called every turn in the market for the past 25 years, you naturally think that its promoter has used this indicator for 25 years – and that he's made a great deal of money acting on it.

But that isn't what "consistent, infallible" means. It means the investment analyst sifted through mountains of historical data (probably with the aid of a computer) looking for traces of a cause-and-effect relationship, until he found the indictor that *would have* worked if it had been used. Then the analyst proclaims the indicator to be "consistent, infallible," and cites the fact that its turnings have always preceded turns in the market.

Asked why this indicator should anticipate a market turn, many analysts will say that the "why" isn't important – since, obviously, it works. Other analysts might rack their brains and come up with very imaginative "why"s.

Coincidence

In most of these cases, the real answer is simply *coincidence*. Many people won't accept that answer because they want to believe that everything is understandable, predictable. But, in fact, coincidences abound in this world.

A pattern can be repeated many times for no reason at all - at least no reason known to us. With a computer, it's easy to document as many recurring patterns as you have time to hear about. But, without an explanation of why a pattern exists, there's no more reason to expect it to continue than there is to expect a roulette wheel to repeat its last ten numbers.

Consequently, when the "infallible" indicator with a 25-year record says "Now!", investors buy but the market continues to move downward.

The advisor will find a way to explain this failure to his audience. But his customers will have been guinea pigs in the "further refinement" of one more infallible indicator.

SYSTEM VS. STRATEGY

An investment "system" is different from an investment "strategy."

A system is an automatic mechanism that tells you, with no room for doubt, when to get in and out of markets.

For example, one system is to compare the trading volume in call options to the trading volume in put options. Supposedly, a ratio below a specified low level indicates that bearish sentiment is excessive and that the market is about to turn upward. A ratio above a certain high level indicates that the market is about to turn downward.

Unfortunately, the good results for any system usually have occurred before you start using it.

A *strategy* is a method for making investment decisions – an *approach* to investing, a way of looking at things, a way of evaluating risks, a method for deciding when the odds are in your favor, and for acting when you've made that decision.

For example, one investor may have captured a profit of 40% in one year, while a second investor had a return of 10%, or broke even, or even had a small loss. The first investor didn't necessarily have the "best" strategy. He may, for example, have risked 80% of his capital on his investments – something the second investor maybe couldn't afford to do. Given enough years (maybe only one or two), the first investor may have no capital left – despite his impressive return the first year.

A few examples of strategy are given at the end of this article.

Luck

Even the best strategy in the world, tailor-made for you alone, won't guarantee success – because there's always an element of luck in your investment results.

"Luck" is a dirty word among "scientific" market traders. But there's no way to get away from it.

To say that luck doesn't enter into your investment results is to say that you control everything that happens – and that you have knowledge of everything that could affect the result.

Obviously, you don't. Luck is the result of all the elements you don't control and can't have timely knowledge of. If these unknowable elements happen to line up against you, your luck is bad. If they work for you, your luck is good. And no matter how diligent you or your advisor are, there's no way to turn all the unknowns into knowns.

A good strategy can't eliminate luck. But a good strategy can help you to capitalize on good luck and minimize the losses caused by bad luck.

Incidentally, when I say that no one can predict the future, people sometimes bring up my 1970 book *How You Can Profit from the Coming Devaluation* (a pretentious book by an immature young man). "How do you explain," the argument goes, "that *you* correctly forecast the devaluation of the dollar?"

The answer is simple. It was my turn to be lucky.

ADVISORS' STRENGTHS

Please don't assume that the purpose of this article is to point out the follies of my competitors. If there were any way to leave advisors' performances out of this, I would do so.

The point of the article is that none of us can know enough about the past, present, or future to invest with certainty. Consequently, it is vital that we have a strategy for dealing with uncertainty and with our own ignorance. But that point is disputed daily by the claims of advisors and the unexamined assumptions of investors. So I can't make the point without also dealing with those claims and assumptions.

Neither should you gather from what I've said that I think investment advisors are useless. In fact, they can be a big help to you.

One thing an advisor offers is his knowledge. Some of it is knowledge of his craft – knowing the conventions and ordinary practices of the markets or the tax rules governing a particular kind of transaction.

Other knowledge is of the many alternatives available to investors – so that he can give you the ability to choose among several ways to accomplish your objectives. Or he may know ways to hedge against risks that are making you uncomfortable.

The advisor might have a better feel for how the world works than you do – or at least better training in logic. He might be able to spot fallacies in arguments that seem convincing to you.

The advisor also can offer theoretical knowledge. Although no one can hope to understand everything about what makes markets move, an advisor should have had the time to understand a great deal more than you do. And this theoretical understanding allows him to see that some ideas and hopes are unrealistic. In this way, he can be a filter for bad ideas – perhaps saving you from expensive mistakes.

He also may be able to spot an investment that has a realistic chance to pay off, and show you how to invest in it with limited risk. And if the investment *is* a winner, he may be able to recognize before you do that the risk-reward ratio, once so favorable to you, is turning against you as the price rises. He may get you out in time to save your profits simply by reminding you that, to succeed, you have to get out at *some* point.

An advisor can do research that you don’t have the time or background to perform. And if he explains his work properly, you can decide for yourself whether to act on what he has uncovered.

He also offers objectivity. He should be able to appraise your portfolio without the emotional interest in it that you have. Understandably, you feel that anything you’ve already bought *must* go up, and so you tend to see only the bullish side – and ignore the information that might tell you that you’re overinvested in some things. The advisor views your portfolio as an outsider; he doesn’t have to argue on behalf of your past decisions.

But don’t expect him to be able to tell you how much profit your portfolio will make (and don’t believe him if he tries to tell you). His analysis should be aimed at seeing whether you’re overinvested in something, what risks you face, whether you’ve chosen the investments that best match your objectives and your opinions about the future.

The advisor should be a teacher, too. He should educate you in the development of strategies that fit your knowledge, interests, wealth, and temperament.

ADVISORS’ DRAWBACKS

Investment advisors also have their drawbacks.

Instead of filtering out bad ideas, some advisors produce them. They promote sure-fire, get-rich-quick schemes that don't work.

As in any business, there are many advisors who aren't original thinkers – who simply relay the ideas of others. And sometimes those ideas live on, in repackaging after repackaging, long after their usefulness has ended.

And, in some cases, an advisor has no knowledge at all to offer you – only an ideological commitment to precious metals or to some other icon. Instead of dealing with the details and specifics that you need, he offers only grand thoughts and slogans. His fervor distorts, his efforts at research, so that he "discovers" only those nuggets that support his predetermined point of view.

Too often an advisor is carrying last years predictions around on his back. The advisor who's guaranteed that gold is going to $2,000 is the last person in the world to evaluate whether you're over-invested in gold. All you'll hear from him are clichés about federal deficits and inflation.

An advisor should help you understand risk and manage it properly. But to many advisors, "limited risk" doesn't mean a stop-loss or another defined way of limiting your losses; it means "there's no chance for the price to drop more than 10%."

Most everyone, advisors included, pays lip service to the concept of uncertainty. But phrases like "Of course, no one can be certain" or "No one has a crystal ball" are too often used only to give an impression of prudence – while the advisor encourages you to fling everything you own into the pot for some sure-fire investment.

Unlimited Wealth

Another problem is that, to most investment advisors, your circumstances and your wealth aren't real. You're just part of the audience that he can see only dimly through the footlights.

In the movie *A Midsummer Night's Sex Comedy*, when Woody Allen is asked what he does for a living, he replies: "I'm an investment advisor; I help people with their money until it's gone."

Actually, in an advisor's view of the world, your money is never gone. You have unlimited funds. The advisor puts you into this investment and into that investment and then into something else. And when he comes up with a new sure thing, he doesn't bother to tell you where the new money is to come from or which of the sure things already recommended must be sold.

He tells you to commit your funds to a bandwagon that is starting to move and won't wait. "This is your last chance to buy at these prices!" But then the price goes down. He never says, "It didn't work, we should cut our losses and get out." Instead, he says, "Wonderful! This is what I was hoping for – an opportunity to buy more at bargain prices!"

Buy more? With what? You've already used up everything – buying on his recommendation at much higher prices.

Unlike Woody Allen, when all the money is gone, the advisor assumes that you can open another dresser drawer and pull out another pile of money. In his world, you'll always have unlimited funds to act on his fantasies.

Your losses simply are not real to an investment advisor. He is right, he has the best record, he is the authority – no matter what happens.

One advisor who has lost an awful lot of money for an awful lot of people began a recent article – as he has begun so many articles over the years: "The principal reason most commentators are confused about the economy is that . . ." No losses will stop him from playing the role of the unique genius who understands perfectly how the world works.

CONTRARY OPINION

How do you deal with this? If an advisor can perform a useful function, how do you tap his strengths without being pulled down by his weaknesses?

One way is to be exposed to advisors with differing views. If your favorite advisor is very bullish on gold, be sure to subscribe to a newsletter that's bearish on gold. Whenever *you* get a strong feeling about something, search out people who disagree.

This is in keeping with the original meaning of Humphrey Neill's "Theory of Contrary Opinion" – *to pay attention to opinions that are contrary to your own*. That makes sense, and it's a far cry from the over-simplified "system" that "contrary opinion" has become – the idea that the majority is always wrong, so that you can get rich simply by acting contrary to the majority.[5]

If you’re sure gold is now in a new bull market, try to imagine all the ways the bull market could be aborted. And once you’ve realized that the uptrend isn’t a sure thing, ask yourself what event would prove you wrong and cause you to bail out.

That brand of contrary opinion simply respects the first rule of investing, which is:

> Anything can happen.

And its corollary:

> There is nothing that *has* to happen.

Often, at investment seminars with many speakers, someone says to me, “I came here to find out what to do about my investments, but now I’m more confused than ever.”

To which, I have to reply, “Good.” If you’re confused, you won’t do anything dangerous or silly. It’s when you’ve found a sure thing, when you’re certain that something must happen, that you’re in trouble.

If one advisor can demonstrate that more inflation is inevitable while another advisor can prove that a deflation is coming, you won’t bet everything you have in one direction or the other. Instead, you’ll try to prepare for both possibilities.

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[5] The original theory is presented *in The Art of Contrary Thinking* by Humphrey B. Neill; Fraser Publishing, Box 4941, Burlington, Vermont 05402; $5,00, postage included.

An economic genius doesn't have to concern himself with opinions contrary to his own. But economic geniuses generally manage to lose great quantities of money – mostly belonging to their customers.

UNCERTAIN WORLD

The beginning of investment wisdom is to realize that we live in an uncertain world, that we don't know enough about how markets work, that we don't even understand the present fully, much less the future.

This uncertainty is a problem only when you try to deny its existence.

In every other area of your life, you deal easily with uncertainty. You don't rely on a fortune teller to tell you how your business will do next year, what your relationship with your spouse will be, who your daughter is going to marry. You know that those things are unpredictable, and you rely on a philosophy of life that doesn't demand predictability.

The investment world is no different. No one can read tea leaves here either. There is simply a lot of talk about things that don't really happen.

No matter what advice you receive, expect to be surprised – because you will be. Over and over again, A is supposed to lead to B, but instead it leads to C or gets swallowed up by D.

To me, the actual results are humbling. It reminds me, over and over again, how little I understand about how the world works – how little I know of natural law.

I believe many things. I have opinions on almost anything you want to discuss. But events keep telling me I *know* very little.

We live in a vast world that none of us can fully understand. We learn throughout our lives, but we are only chipping away at the ignorance – not eliminating it.

Growing Up

Throughout your entire life, you are only trying to grow up – to understand how to act, how to think, what to do to get what you want.

Every year, you look back and say, “I didn’t understand everything last year, but now I won’t make those mistakes again.”

And you *won’t* make those mistakes again. You’ll make new ones.

Every once in a while, I’m perceptive enough to remind myself that, if last year’s ideas seem so immature today, today’s ideas may not look so hot next year.

HOW YOU LIVE

The fact that we live in an uncertain world doesn’t mean there’s nothing you can do about your investments. You’ve managed to deal with the rest of your life successfully – in areas offering no more certainty than the investment markets offer.

In the real world, no one guarantees that you’ll have a job forever. But that doesn’t stop you from working and earning a good living.

Nor does anyone guarantee that your loved one will be with you always, but that doesn’t stop you from enjoying each other today, tomorrow, next month, next year.

Despite the uncertainty, you know there are ways to succeed in every other area of your life. Why not with investments as well?

When you enter the investment markets, you aren't entering a Twilight Zone where reality is overruled. The markets are part of the same real world in which you've made all your other decisions.

You cope in the real world because you've developed a philosophy of life that helps you to make decisions without perfect knowledge of the consequences. You can do the same in the investment markets if you've developed a strategy for making investments without perfect knowledge of the results.

And as with your philosophy of life, that strategy should restrain you from going overboard, from letting enthusiasm run away with you – even as it allows you to be as speculative or as cautious as you *choose* to be.

Your strategy – as with your philosophy – should be formulated to take advantage of your strengths and your interests, without requiring that your weaknesses disappear.

MYSTICS

Many people are unwilling to accept the world as it is. And so they study eastern religions, Extrasensory Perception, numerology, or astrology, or they take drugs – hoping that something will connect them with a higher intelligence and give them an edge on everyone else.

Although they don't call it so, what they're looking for is *magic* – a way of bending and escaping the natural laws that govern the rest of us.

The same flight from reality occurs in the investment markets. People look for secret indicators. They endow trendlines on charts with magical significance – even though no one (to my knowledge) has ever explained why a trendline has *any* significance. They divine truth from chart patterns, much as witch doctors read meaning in the entrails of animals.

They offer no explanation of human cause and effect at work. As with any mystical system, the only explanation is, "It works." But, of course, it rarely seems to work when *your* money is at stake.

They want to believe they've found the secret in Elliott waves, or in Kondratieff waves, or in the conspiracies of stock exchange specialists, or in meetings of the Trilateral Commission, or in January barometers.

They consecrate indicators, such as "relative strength," that tell you where you should have been invested last month.

They draw triangles and squares. They worship Fibonacci numbers and – most of all – the "golden" number 1.618.[6]

A common thread through most of these mystical systems is the invocation of mathematics. But economics deals with qualitative, not quantitative, relationships.

To paraphrase Francis Bacon, a little mathematics is a dangerous thing. Ludwig von Mises said that every economist should have a

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[6] Leonardo Fibonacci (1170-1230) was an Italian mathematician who devised a numerical sequence 0, 1, 1, 2, 3, 5, 8, 13, 21, 34, 55 . . . etc., in which each number is the sum of the two preceding numbers. Modern mystics believe that the numbers I the sequence are market tools. It isn't too hard to point to examples, such as an uptrend that lasted 8 months, for instance – especially since half the numbers between 1 and 10 are Fibonacci numbers.

If you fail to see the divine purpose in all this, Fibonacci buffs deliver the coup de grace – the fact that the result of dividing any number in the sequence by its predecessor is approximately 1.618 (55 divided by 34 = 1.618). Now try and explain that away!

thorough understanding of mathematics – just so he'll know how little mathematics has to do with economics.[7]

THIS IS IT

There are no mystical secrets hidden behind the curtain that would enable you to read the future – in the markets or anywhere else in life. The world you see is the world you get.

There are no secret weapons, no guaranteed trading systems, no special indicators, no hot hands, no ways to beat reality.

We live in a world of uncertainty. Safety, profit, and peace of mind begin the day you quit wishing you could find an infallible system and start devising a strategy based on uncertainty.

STRATEGIES

My strategies of the past six or seven years have been described in my last two books and in many articles in this newsletter.

The heart of my approach is to separate the money you're trying to conserve from the money you're willing to risk for the sake of bigger profits – separating your capital between what I call the Permanent Portfolio and the Variable Portfolio.

For the Permanent Portfolio, it's important that you don't bet everything on one outcome – that you protect yourself against uncertainty instead of just giving lip service to caution.

The use of "leveraged" hedges (very volatile investments that could triple or quadruple while only risking the amount invested) is a good example of the use of a strategy to accomplish an objective – in this

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[7] Paraphrased from his statement on page 4 of The Ultimate Foundation of economic Science, 1962 Van Nostrand edition.

case, the objective of being protected in several directions without immobilizing the portfolio.

For the Variable Portfolio, it's important to have a basis for deciding when to invest in something – not just when something "ought to go up," but when you see a good reason that the potential gain can be several times what you're risking. And it's important to define precisely what is being risked – not through a pointless guess as to how far the price can drop, but by deciding how far you'll *let* it drop before you get out.

An implicit part of any realistic strategy (to me) is the recognition that the investment opportunity you see isn't something that *will* happen – but something that has a higher-than-average chance to happen. The difference between those two approaches is crucial to making the proper arrangements for the investment.

These are brief examples of elements of my investment strategy. Although I've discussed them over the years, the presentation has been fragmented – as various parts have been described to deal with current questions or objectives.

These ideas need to be consolidated, as well as polished in a number of respects. So I plan to publish a new series of articles integrating the strategies for dealing with an uncertain investment world – setting forth the principles I believe underlie the use of both the Permanent Portfolio and the Variable Portfolio. These articles should appear in the next few issues.[8]

IT HAPPENS TO ALL OF US

I'd like to close this lengthy article by showing you that I do understand how authoritative and compelling investment advice

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[8] Meanwhile, the article "Forecasting vs Strategy" covers a lot of the Variable Portfolio strategy.

sometimes can be – how strongly you can be made to feel that if you don’t act now, you’re going to miss the boat.

Last February, I met for the first time an advisor whose work I’ve read and respected for many years. In our conversation, I said, “Isn’t it funny how many times during the past few years various advisors have announced the beginning of a new bull market in gold?”

He said, “Yes, many people have jumped the gun.”

And then he added, “But you know, the bull market did begin today.”

At first I thought he was kidding, but then I realized he was serious and I stopped giggling. “Today? Why do you think that?” I asked.

“Well, the London fix was over $390, the 5-week moving average finally rose above the 13-week average, ...” etc.

For the past 40 years, I’ve been the secretary-treasurer of the National Organization of Worldly Agnostic Youth (NOWAY). You know me, I’m skeptical of *everything*. But I must admit that, as I sat there listening to him, I thought to myself. “Am I missing out on something? Should I run home, call my Swiss bank, write a Special Bulletin?”

Needless to say, I sobered up. And needless to say, a new bull market in gold didn’t start last February.

But if I can be moved by such authority, I well understand how you can get stampeded sometimes by plausible, compelling claims – how it can seem that someone *knows* what’s about to happen and you’d better pay attention.

But that someone is just a human being like you and me. He meets his margin calls one leg at a time, just as you do.

He lives in the same vast, uncertain, inexplicable world where you and I live.

INVESTING IN AN UNCERTAIN WORLD

September 18, 1984

In "How Little We Know," I said that theories about economics aren't as reliable as the theories of the physical sciences – that we know very little about how the economic world works – and that no one can predict the future usefully – in short, that we live in an uncertain world.

This article introduces, in general terms, my strategy for investing in an uncertain world. Future articles will provide the specifics.

I believe this strategy best fits the kind of world we live in. It's aimed at safety and profit without depending on anyone's ability to foresee the future.

I'm sure I'll continue to amend it as I learn more. I might even trade it for a better one someday. And yet one of its characteristics is its apparent timelessness. I believe this strategy would have been suitable during the 1920s, 1950s, or any other period I know about. So it stands a good chance of being just as applicable in the 1990s or 2000s.

EXPECTATIONS

Even though you live in an uncertain world, you still have expectations. You can't look at the present without forming an expectation about what is going to happen next, and it would be unreasonable to ask someone to ignore what he thinks that future is likely to bring.

But what you *expect* to happen is only that – an expectation, not an event already recorded in the history books.

You don't have to ignore your expectations for the future. On the contrary, you won't be happy unless you act on them. But you should do so with limits and restraints, and with a plan for controlling the damage when you're wrong.

By recognizing that an opinion about the future is *only* an opinion, and not a revelation of the future, you'll act on it in a safer way. And the safer way leads to much greater success than if you bet the ranch every time you think you know what's coming tomorrow.

TWO PORTFOLIOS

I believe the most important way in which you can acknowledge the uncertainty of the future is by separating your investment capital into two portfolios. I call these the Permanent Portfolio and the Variable Portfolio.

A portfolio is simply a collection of investments – such as a number of different stocks, a quantity of gold, parcels of real estate, cash, etc.

The Permanent Portfolio is a balanced collection of long-term investments. Its purpose is to assure that you're financially safe no matter what the future brings. It accomplishes this through a special plan for diversification that's discussed later in this article.

The Permanent Portfolio can be slanted toward your general opinion about the long-term course of the economy, but it should be arranged so that you won't be hurt badly if it turns out that your expectations are wrong.

The Permanent Portfolio, once in place, is meant to remain virtually unchanged for several years. You don't alter it as the economy bounces from recession to prosperity to inflation.

The primary concern of the Permanent Portfolio is safety. But if the portfolio is properly constructed, it can produce a profit as well.

The Variable Portfolio, on the other hand, is funded with money you can afford to lose. It is a separate portfolio, with which you attempt to capitalize on shorter-term investment trends. Its investments change as you see the opportunities for profit changing.

The contents of the two portfolios don't have to be physically separate. For example, you might have a single account at a money market fund for $20,000 – of which $15,000 is part of your Permanent Portfolio and $5,000 is part of your Variable Portfolio.

The important thing is to treat the two portfolios separately when you make investment decisions. Each has its own purpose and its own rules.

For example, if someone convinces you that "Bonds are a terrific buy at these prices," you'd consider whether the Variable Portfolio should make an investment in bonds now. You wouldn't alter the Permanent Portfolio's bond holdings – no matter how strongly you felt about the near-term future for bonds.

Value of Two Portfolios

The separation of your assets into two portfolios may seem to be a mere formality. But I believe it's a vital part of the strategy for dealing with an uncertain world.

It identifies a certain portion of your assets as eligible for betting on the future – and restricts and protects the rest of your assets. Without that separation, all of your capital is exposed to the hazards of mistaken forecasts, ill-timed speculations, hot tips, and your own runaway enthusiasm.

For example, when your favorite investment advisor says, "Now is the time to throw caution to the wind and bet everything on a new bull market in gold," he may decide to mortgage his home and bet everything. But you can keep your caution out of the wind – and limit your bet to all or a portion of your Variable Portfolio. If the future turns out to have been less certain than the advisor believed, you'll have lost only what you could afford to lose.

Of course, if it turns out that he was right – right in every detail – your profits won't be as great as if you'd traded your Permanent Portfolio for a gold bar. But, unfortunately, you don't know in advance whether this is the one correct by signal out of the many that will be announced.

No matter how earnest you may be about limiting risk, keeping all your capital in one portfolio makes it too easy to overspeculate. Every time a new speculative opportunity arises, you'll reopen the question of how much of your capital is available for speculation. And the chances are great that your answer will be determined by how strongly you feel about the current speculation – not by how much you can afford to lose.

THE PERMANENT PORTFOLIO

The first purpose of the Permanent Portfolio is to preserve your capital no matter what economic environment descends upon us – more inflation, runaway inflation, an end to inflation, deflation, prosperity, whatever.

In the real world, there's no one course of action that could assure your financial survival through every conceivable eventuality. But you should be able, through moderate diversification, to be 99% sure that your capital will survive just about anything short of an event that destroys civilization.

This safety is achieved by making sure that any future economic climate will cause at least one of the portfolio's investments to be a big winner. And the profit in the winning investments must be great enough to offset losses in the other investments.

To make this possible, the Permanent Portfolio should favor investments that are highly volatile – that move great distances, up or down, as conditions change. Over a period of several years, the profits in the winners are likely to be several hundred percent, while the worst loser can't lose more than 100% of its starting value.

Thus one winner can outweigh a number of losing investments – creating a net profit overall. During the 1970s, for example, the gold in a Permanent Portfolio gained 300%, 400%, or more – far overshadowing losses of 30% to 50% in the stocks and bonds in the portfolio.

In addition to offering volatility, the Permanent Portfolio's investments must be tied closely to specific economic climates. Four particular investments offer these virtues, and thus are essential to the portfolio:

1. Gold – to profit during periods when the inflation rate is rising;

2. Stock market investments – for periods of declining inflation and/or general prosperity;

3. Long-term Treasury bonds – for periods when interest rates are declining, such as during most periods of falling inflation rates and especially after a deflation;

4. Treasury bills – the one non-volatile investment, in order to provide liquidity, to offer some stability during periods when no investments are doing well (such as 1980-1982), and to provide purchasing power appreciation during periods of low inflation or deflation.

These investments are the cornerstones of the portfolio – because each has a strong and clear link to a specific economic environment.

The portfolio might also include real estate, silver, foreign currencies, a business, or any other long-term investment that seems right to you. However, these investments aren’t essential to a Permanent Portfolio. They should be included only to achieve a small additional degree of diversification, or when you believe an investment is available at a bargain price in a long-term sense, or when needed for tax advantages.

If you arrange the Permanent Portfolio thoughtfully, it can remain relatively unchanged for many years – and should require only minor attention about once a year or so. It should be a portfolio you can walk away from without ever having to fear that it has become inappropriate for the times. And it should be so well-balanced that no news item can make you feel vulnerable.

If you rely on your investments for living expenses, it’s the Permanent Portfolio that generates the cash you need – since it’s the Permanent Portfolio that’s designed for reliability. The cash may come from interest and dividends earned by the portfolio, or it may come from selling small amounts of profitable investments.

THE VARIABLE PORTFOLIO

The Variable Portfolio begins with a supply of cash. It continues to be 100% in cash until you see an attractive speculation – at which time some or all of the portfolio’s cash might be put into that investment.

A Variable Portfolio investment might be very short-term – such as a trade that’s expected to last only a few days in the futures markets. Or it might be medium-term – a bet that an item is now in a bull market that could last for six months, a year, or more. Because of its format, the newsletter’s Variable Portfolio investments are invariably of the latter time frame, but there are no rules against very-short-term investments.

At times, the portfolio might be divided among two or more investments. But when nothing is attractive, the Variable Portfolio remains in cash – which might be in the form of Treasury bills or a money market fund invested in Treasury securities.

The Variable Portfolio on occasion might be invested in an item that's also in the Permanent Portfolio. If so, the item serves a different purpose in each of the two portfolios. It's in the Permanent Portfolio because of the long-term protection it provides; it's temporarily in the Variable Portfolio because you expect it to appreciate – and soon.

It's important to have a specific strategy for the Variable Portfolio – rather than simply betting it on whatever plausible story comes along. You need a way to evaluate potential investments within the context of all your speculations – not as if a potential investment were the only one you'll ever make.

A future article will outline the strategy I use for managing the Variable Portfolio.

The Variable Portfolio should be funded with money you can afford to lose. If properly handled, you probably won't lose all of it – even if every one of your speculative investments turns out badly. But it would be foolish to speculate with money that's precious to you.

DIVISION BETWEEN THE PORTFOLIOS

The first important decision concerns how you'll split your capital between the two portfolios.

The answer comes from two considerations:

1. How much of your capital you're willing to risk.

2. How confident you are that you can manage the Variable Portfolio profitably.

It isn't essential that you have a Variable Portfolio. For some people, it's better to have 100% in the Permanent Portfolio and nothing in the Variable Portfolio. This is the best situation if you have no interest in short-term speculations, or if you don't have the competence or the time to speculate intelligently, or if everything you have now is precious to you.

If you don't now have capital you can afford to lose, you shouldn't set up a Variable Portfolio until your net worth has increased to the point that you feel you have a surplus to risk.

If you have funds you can risk and you'd like to have a Variable Portfolio, but aren't sure how well you'll do with it, you might put 10% or 20% of your net worth (up to the limit you're willing to lose) into the Variable Portfolio. If you're anxious to speculate and can afford to jump in with both feet, you might have much more in the Variable Portfolio.

After you've determined how much of what you have now is precious to you, leave more than that in the Permanent Portfolio. There are bound to be periods when the portfolio will depreciate in value. Between 1980 and 1982, for example, virtually all investments except Treasury bills declined in value. During such times, any portfolio except one that's mostly in cash has to decline in value also.

So if you decide that, say, 50% of your net worth is precious to you, you might leave 65% in the Permanent Portfolio and put 35% in the Variable Portfolio.

Naturally, it's better to make the division between the two portfolios at a time when you don't have a specific speculation in mind. Undistracted by the scent of hoped-for gain, you're better able to weigh the subjective balance between risk and possible profit.

In fact, a big advantage of having two portfolios is that it will have been during a time of calm that you decided how much you can afford to risk – not when someone's yelling in your ear to jump at a once-in-a-lifetime chance to make your fortune.

This, in turn, permits you to be more aggressive with the Variable Portfolio. Knowing that you aren't risking the family jewels, you can be as daring as you want to be. No matter what happens, you know you have a safety net – the Permanent Portfolio – underneath you.

Testing the Division

After you've made the division between the two portfolios and have lived with it for a while, you can apply three tests to find out whether the division is right:

1. How would you feel if the entire Variable Portfolio were wiped out? If such a loss would disrupt your life and lead to drastic changes in your plans, then your Variable Portfolio is too large.

2. Do you find that the Variable Portfolio is never fully invested? If so, this may be a sign that it's too large – since you may be unwilling to risk it all. (It's also possible, however, that your Variable Portfolio hasn't been fully invested because you haven't yet found opportunities that are attractive enough. This has been the case for the newsletter for most of the past four years.)

3. Have you dragged your feet in setting up a balanced and diversified Permanent portfolio because you're waiting for investment prices to change? This may be a sign that your Variable Portfolio is too small - since you're actually speculating on future prices with money that you'd allocated to the Permanent Portfolio. (It also may mean that you don't fully accept the Permanent Portfolio concept.)

TRANSFERS BETWEEN PORTFOLIOS

If investment losses reduce the value of your Variable Portfolio, you might be tempted to refinance it by drawing on the Permanent Portfolio. This would be a big mistake.

New money for the Variable Portfolio should come only from one of these sources:

1. Profits on investments made with existing Variable Portfolio capital;

2. Gifts or income from outside your investments;

3. Increases in value in the Permanent Portfolio that create additional funds you're willing to lose.

   Only if the Permanent Portfolio is generating profits should you draw money from it to replenish the Variable Portfolio. And you need to be careful not to overestimate the Permanent Portfolio's surplus.

On the other hand, if the Variable Portfolio is successful, you may want to transfer some of its profits to the Permanent Portfolio. Even though it's money you could afford to lose, you may want to "bank" some of your profits. You don't have to be like the casino gambler who keeps betting his winnings until he's finally lost everything.

You may also want to withdraw some of the Variable Portfolio profits to spend on yourself and your family.

Transfers of funds between the portfolios, if any, should always be governed by the same basic standard that controls the original division of assets between the two portfolios: How much are you willing to place at risk by betting on your judgment about near-term market trends?

SPECULATION AND SAFETY

I realize that most people give lip service to uncertainty and to the need to control risk. But, having *said* the right things, many people make investments that indicate great confidence and little humility. Often this happens because the difference between safety and speculation hasn’t been defined.

With many investment strategies, you’re told that safety comes only from outguessing the future (which is speculation, no matter what it’s called) – that you must bet everything on inflation, or on deflation, or on how many photos the Chinese will take or on something else. If things don’t work out as expected, you pick up whatever pieces are left and start over again from scratch.

Other strategies aren’t based on a single long-term bet. Instead, you’re told that safety comes from agility – from moving quickly from one investment to another as the economic climate changes.

This leads to a series of speculations in which you stake everything - over and over again – on someone’s ability to read the situation correctly. One or two wrong guesses and you may have to start your financial career all over again – with a small fraction of what you have now. Somehow, this strategy also bears the “safety” label.

I believe it’s possible to create a portfolio that’s much less vulnerable to the world’s uncertainties than is the idea that someone (you or an advisor) will always guess right about the future. And that portfolio – the Permanent Portfolio – should be keep separate, out of reach of tinkering hands, unavailable for bets on the latest forecast.

It isn’t foolish to speculate. But I want to speculate intelligently – betting only with money I can afford to lose and only when the odds seem to be stacked in my favor.

If I’ve placed a firm limit on the amount I can lose, I can speculate freely – without the pressure of always having to be right. With that protection, I probably will speculate more coolly, more intelligently, more profitably than if I fear the terrible consequences of betting wrongly with everything I own.

INSIDERGATE

December 3, 1986

This seems to be the year for scandals, and Wall Street has one of its own. But our protectors at the Securities & Exchange Commission (SEC) will keep us safe from harm.

Being against insider trading is like being against sin or being for apple pie. No decent, God-fearing person wants to see insiders take advantage of honest investors.

Unfortunately, apple isn't one of my favorite pies, and I'm not even sure I'm against sin. So I'm having trouble getting myself worked up about insider trading.

The current pronouncements are consistent with the great American philosophy: "If you don't get what you want, sue somebody." Whatever happens, don't take responsibility for your own life. Investors shouldn't have to think for themselves, and they shouldn't have to feel responsible for their investment losses. There are bad men out there who took advantage of them.

The insider scandals have raised again the concept of the "level playing field." We're all supposed to compete on the level playing field of life — in which, I suppose, no one has the advantage of being able to run downhill. I guess this means that all financiers will have to go to the same school of business, and all doctors will have to go to the same medical school — to avoid giving anyone an unfair advantage over his competitor.

There are so many mistaken assumptions and fallacies in the current insider witch hunt that it's hard to know where to start.

Zero Sum Games

In the first place, investors are not necessarily competing with one another. The investment markets are not "zero sum games" in which one player's gain is offset by a loss to someone else. If they were, they would have faded out of existence years ago — replaced by casinos that offered free drinks as you gamble.

When two people exchange money and stock, the transaction is not much different from two people exchanging money and doughnuts — a mutually profitable exchange. No economist in his right mind would call the two people "competitors" or attempt to identify which is the "winner" and which the "loser."

If a man buys a stock at $30 and sells it at $42 to another man who later sells it at $51, which is the winner and which is the loser?

The answer is self-evident. Each is a winner, and each unintentionally helps the other as he pursues his own goals. It's just like any other free market transaction.

What if one of those two investors had "inside" information? By competing on a tilted playing field, did he hurt the other investor?

Let's suppose Mr. Outsider bought the stock at $30 and then decided on June 1 to sell — and did so at $42. Mr. Insider obtained some very special information on June 1 about something that would occur on June 10. So he bought at $42 from Mr. Outsider. On June 10 the expected event occurred on schedule, the price jumped to $51, and Mr. Insider sold and took his profit.

The fairness buff sees this example and concludes that Mr. Insider made his profit at the expense of Mr. Outsider. But that assumes, even if it's not recognized, that Mr. Outsider sold only because Mr. Insider wanted to buy.

In fact, Mr. Outsider sold for his own reasons. If he hadn't sold to Mr. Insider, he would have sold to someone else. And if Mr. Insider's presence in the market had any effect upon Mr. Outsider, it must be that Mr. Outsider received a higher price for his stock than if Mr. Insider hadn't been bidding for it.

No, says the fairness buff, you don't understand; Mr. Insider should have made his information public before he bought the stock.

But if Mr. Insider had to make public his information, he wouldn't buy the stock at all — since the price would already have risen by the time he could buy. And if he can't buy the stock without revealing the information, he probably won't bother to do either. So Mr. Outsider still would have sold his stock at $42.

Mr. Insider didn't cost Mr. Outsider anything. So how would a level playing field make Mr. Outsider any better off? (Even if Mr. Outsider sells at a loss, the principle is the same. He would have had the same loss if Mr. Insider had stayed out of the market.)

Wait a minute — we're forgetting someone. What about Mr. Latecomer — the poor guy who bought Mr. Insider's stock at $51, at the very top?

Mr. Insider didn't make the stock rise to $51; he didn't create the event that caused the price rise; he only profited from it. The stock would have gone up in any case — and Mr. Latecomer would have lost in any case.

The essence of the insider-trading argument is the idea that no one should have access to help that you and I don't have. But everyone's situation is different. Some people have better computers, subscribe to more newsletters, get phone calls in the middle of the night warning them of market crashes, have a better feel for the market, get better executions from their brokers, receive free advice from their brothers-in-law, and in many other ways enjoy unfair advantages. Where do we draw the line?

Heard in the Alley

The Foster Winans case was a landmark in government efforts to protect the public.

Mr. Winans wrote the "Heard on the Street" column for *The Wall Street Journal*. The column reported good or bad opinions about individual stocks — opinions coming from "savvy" Wall Street traders.

He had a roommate who knew in advance what the column would say. The roommate and a broker conspired, with Mr. Winans' knowledge, to buy ahead of time the stocks that were to be touted in the articles. As such, they supposedly made profits on this inside information.

If their profits came at any investors' expense, it would have to be those who bought a stock after an article appeared — because the roommate's advance purchase would have made the stock slightly more expensive than it would have been otherwise.

But so what?

A basic investment rule is never to buy an investment because of the publication of good news. It will be a tough job to protect investors who think they can get rich by buying stocks touted in *The Wall Street Journal* — because those people need a lot more protection than just the elimination of insider trading.

Employers & Employees

Since *The Wall Street Journal* is a respectable newspaper, it’s not likely to look kindly on employees who get involved in such schemes. For one reason, it wouldn’t want the columnist choosing stocks for his columns according to how well they suit his private scam.

And so one would expect *The Journal* to have rules about such things — as in fact it does. If it didn’t, *Investor’s Business Daily* could gain an edge by providing a similar column with more useful information.

The situation is similar for law firms, accounting firms, investment banks, and other companies whose employees might be aware of sensitive information. It’s bad for business to become known as a company that can’t keep a secret. (Look at the CIA.)

So most of these companies require employees to sign secrecy agreements. They are even in a position to sue former employees who have violated their oaths.

And that’s the real point. The injured party isn’t an investor rolling down a tilted playing field. The “victim” is the company whose employee has violated his contract.

In the Ivan Boesky case, the culprit is the individual who sold Mr. Boesky information that the culprit had promised not to reveal. And the victim is the company that person worked for. As such. it is properly a civil matter, not a criminal.

So why do we need SEC storm troopers to regulate what insiders do?

Victims?

The crusaders are always on the lookout for a new class of victims — for whose protection new legislation will be urgently needed. Victims have already included Negroes, women, homosexuals, tenants, borrowers, employees, and so on.

The newest victim is the investor who is being denied his rights under the 37th Amendment, to wit: “No investment exchange, dealer, or broker shall deny a level playing field to any investor.” After all, a lone investor is helpless. How can one person by himself hope to compete with the Ivan Boeskys of this world?

Actually, that’s one reason we have mutual funds pension funds, commodity pools, limited partnerships, money managers, financial broadcasting, and (dare I say it?) investment newsletters. All these things enable an investor to have professional help.

If someone loses money continually in the investment markets, it isn’t because there are insiders, arbitrageurs, market-making specialists, floor traders, scalpers, raiders, or other bogeymen. He loses money because he isn’t a competent investor. No matter what laws are passed, he’ll continue to lose money until he learns to be a better investor or he delegates the job to someone more competent.

Insider Losses

One way the witch hunters attempt to rally the public is to call attention to the obscene profits of the witch who’s being hunted. It’s assumed that inside information is a license to print money.

Unfortunately, the SEC doesn’t compile statistics showing the number of times that “inside information” didn’t pay off. They have too much to do making pitches for an enlarged staff of prosecutors.

Although we’ll never know, I suspect that more money has been lost with inside information than gained. Many times in my investment career, someone has told me about information that came from a special source — none of which ever proved to be worth anything.

My favorite example was the head of the precious metals department at a “Big 3” Swiss bank, who guaranteed to a friend of mine in 1970 that gold would never go above $40. Asked how he could be so sure, he said, “Because we control the market.”

There are newsletters devoted solely to tracking the (legal) transactions of company officials dealing in the stocks of their own companies. If insiders know something we ought to know, those newsletters ought to be racking up outrageous profits for their subscribers. But somehow they seem to be in the same slow-pitch league where we mere mortals play.

Pandora’s Box

The grandstanders on Capitol Hill will do their best to capitalize on the insider trading excitement. It may not be IranGate, but you do the best you can with what you have. Appropriate legislation will be passed to make the playing field more level as defined by Senator Kennedy or Senator Cranston.

Even if you find my arguments about insider trading empty, I hope you aren’t foolish enough to think the government is going to solve the problem for you. The government can’t enforce your wishes without the wishes of millions of other people being added to the package. If you get what you want, you’ll also get a lot of things you hadn’t bargained for.

The net result will be less efficient markets, higher costs in trading and investing, wider bid-ask spreads, higher costs for legal insurance, and the suppression of information that’s available now. But none of these costs will come with a tag attached saying, “Necessary because of insider trading prosecutions.

For & Against

I don’t bother raising arguments in this newsletter unless I think those arguments are being overlooked elsewhere.

And, although I haven't seen much sense written on this subject so far, I probably wouldn't have raised it if it hadn't been for one thing.

On November 24, the Financial News Network (a television network that provides market news all day) reported that attorneys had filed a number of class-action suits on behalf of investors against the infamous insiders. The reporter named the stocks involved, and invited viewers who had bought the stocks between certain dates to participate in the suits. The network even displayed the names of the attorneys and their telephone numbers on the screen. And so the journalists and the ambulance chasers are joined.

I have to remind myself occasionally that financial journalists are merely journalists specializing in finance. As such, they're no more aware of what makes the world go 'round than other journalists are — and so they're not able to comprehend the nature of a free-market transaction between consenting adults.

THE 10 GOLDEN RULES OF MUTUAL FUND INVESTING

Mutual funds are a convenient way to carry out whatever investment strategy you want to employ. But it is as easy to choose the wrong mutual fund as it is to select the wrong stocks or bonds. Here are ten golden rules to help you find your way to funds that are right for you.

PURPOSE OF THE INVESTMENT

Rule #1: <u>Ask yourself what you want from a fund.</u>

Are you buying it:

- Because you think the investments it holds are going to be especially profitable?
- Because you think the fund's manager will be especially clever at picking the most profitable stocks or bonds, or at knowing when to be in the market and when to be out?
- To hedge against other investments you hold?
- To enhance the balance of a diversified portfolio?

If you're not clear about your purpose, you can't even begin to sort through the thousands of mutual funds available.

YOU DON'T KNOW WHICH FUND WILL PERFORM BEST

Rule #2: <u>Don't count on being right when you try to pick winners</u>.

You have no way of knowing which funds will perform best next year. The success rankings of mutual funds continually change. This year's star may come from last year's unknown, and last year's best fund may fall to the back of the pack.

My favorite example is Strategic Capital Gains — which was the #1 fund for the final quarter of 1985 from among 973 funds monitored by

Lipper Analytical Services. The very next quarter, the fund was 973rd — dead last.[4]

Obviously, you don't want a fund that never has a good year — but, in most cases, last year's performance tells us little about a fund's future.

The word "performance" usually refers to whether a fund has beaten the market and outperformed similar funds. But you do want to check a different kind of performance — whether the fund's record matches your purposes.

For example, suppose you have a diversified portfolio that includes some stock investments. It's important that the stock investments do well whenever the stock market rises, so you want to confirm that a stock fund has gone up substantially whenever the market has risen. That's more important than the fund's overall record in bull markets and bear markets alike.

On the other hand, if stocks are always your primary investment, you need to protect against sharp stock-market declines that could devastate your portfolio. So you'd check to be sure a fund has held up well during bear markets — even if it hasn't been a top performer during bull markets.

In other words, (1) decide what you need from a fund, (2) look for one whose policies seem to match your need, and (3) then see whether the fund's record confirms that it performs the way you expect it to.

WHAT ARE YOU TRYING TO ACCOMPLISH?

Rule #3: <u>Decide whether you want to invest or speculate.</u>

When you <u>invest</u>, you protect your capital from depreciation, confiscation, inflation, or anything else that might take it from you.

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4 <u>Barron's</u>, May 19, 1986, page 47.

And you accept the rate of return the markets are providing to investors generally.

When you speculate, you put your capital at risk in an attempt to beat the market — to get a better return than other investors are earning, to outguess the future, to win big by being in the right place at the right time.

If you had most of your money in blue-chip stocks in October 1987, you may have believed you were investing. But by concentrating your capital in one place, you were speculating — guessing that stocks would continue to be the leading investment. And your wrong guess cost you dearly.

You're speculating whenever you bet everything you have on one investment, on your ability to get out when the investment peaks, or on your belief that you or your favorite advisor knows more than other investors. You're speculating — even if someone assures you that you're being conservative.

There's nothing wrong with speculating — provided you do it with money you can afford to lose.

If you're investing, you must choose a fund that helps your portfolio prosper from whatever may come. If you're speculating, you will look for the fund likely to profit the most if your view of the future turns out to be correct.

GETTING RICH

Rule #4: Your chances of beating the market are slim.

Investors and advisors talk a great deal about beating the market averages, but few people actually accomplish it for long. I've been in the investment business for over 25 years, and I've met, heard, or read all the leading personalities. But I've never come across anyone who could reliably outperform the market for any length of time.

Of course, everyone has his lucky periods. I know I have. And all of us talk about our winning streaks. But no one ever seems to repeat yesterday's success.

The first principle of investment advice is: The advisor with a perfect track record up to now will lose his touch the moment you start acting on his advice.

There's a good reason for this. You don't hear of an advisor or fund until it has compiled its fantastic record — only then does it come to your attention. But by this time the lucky streak has about run out.

The Hulbert Financial Digest monitors the model portfolios of over 100 popular investment newsletters, noting every recommendation, to determine how profitable the advisor's advice has been. The newsletter with the best 7-year record through June 30, 1987, had compiled a gain of exactly 600%, which is a compound profit of 32% per year — which seems much too good to be just luck. But anyone acting on this newsletter's recommendations would have lost 57% of his capital four months later, when the stock market crashed.

Of course, even after that disastrous month, the newsletter still had a 200% profit since 1980. But that was irrelevant to most readers. Hardly anyone had followed the newsletter's advice continuously since 1980, because hardly anyone knew it existed before 1987. Only after the winning record was compiled did investors become aware of the newsletter. And by then the lucky streak was over.

That applies equally to mutual funds. We hear about fabulous records. But, of course, all of them are after the fact — and no one can direct us to the next success story.

As I said, there's nothing wrong with speculating — provided you do it with money you can afford to lose. But don't risk the capital that's precious to you on a bet that some fund will outperform the market.

100% INVESTMENT

Rule #5: Be sure the fund stays fully invested.

It is common for a mutual fund to speculate — altering its exposure to the market as the fund manager's outlook changes. If a stock fund manager is bullish, his fund might have 90-100% of its assets in stocks — but then switch to a large cash position when he turns bearish.

This is market timing, and it can make a fund useless to you. When you buy such a fund, you buy the fund manager's opinions about the future of the market — which aren't likely to be better than anyone else's.

The manager's market timing efforts defeat your purpose. If the fund is meant to be the stock portion of a diversified portfolio, or if you're speculating that the market is headed upward, your investment strategy will be frustrated if the fund manager turns bearish and reduces his stock holdings.

Almost always, you're better off to buy a fund that's always fully invested — so that 100% of your purchase goes into the investment (stocks, bonds, or anything else) you've chosen. That way you regulate your exposure to the market by how much money you put into the fund.

LOOK FOR VOLATILITY

Rule #6: A volatile fund can be safer than a stable fund.

Volatility is the degree to which an investment's price fluctuates relative to similar investments. The more volatile a fund is, the further it moves as its underlying market moves. For example, a very volatile stock fund might change in value by 50% (up or down) when the stock market itself moves by only 25%.

That a volatile fund can be safer seems paradoxical. But, again, keep your eye on what you want to accomplish.

As the stock market fluctuates, a volatile fund has a greater impact on your portfolio. Thus you can get the same profit from a small position in a volatile fund that you would with a big position in a slower-moving fund. This frees up capital for other investments — such as Treasury bills or even gold — that can help offset your stock losses if the stock market goes down. A volatile fund lets you buy hedges without sacrificing any profit potential.

If you think stocks are about to rise and you want to bet on it with your speculative capital, you can limit the amount you put at risk by using a volatile fund. No matter how volatile it is, you can never lose more than you invest — but if the market goes up, the volatile fund will make more for you.

Published tables that compare mutual funds often include a column labeled "Beta." It measures how volatile a fund is and how reliably it moves in the same direction as a particular market (which, for a stock fund, is usually the S&P 500 index).

Basically, the higher the beta, the more the fund satisfies this golden rule of fund investing.

Sometimes a table rates fund volatility by "Standard Deviation." This is a different measurement — but, again, the higher the number, the more volatile the fund tends to be.[4]

DON'T BE PENNY FOOLISH

Rule #7: Pay no attention to the makeup of a fund's expenses, and don't place too much importance on total expense.

Many financial journalists spurn mutual funds with 12-b-1 plans. But why should we care about 12-b-1 plans? If expenses matter at all, it's total expenses and not the kind of expenses that should concern us.[5]

And many advisors tell investors to choose the funds with the lowest expense ratios. But such advice needs to be qualified. It is a fund's net result that affects our capital. How the fund achieves that result doesn't matter. If two funds perform roughly the same year after year, it shouldn't matter that one spends liberally on advertising and lavishes perqs on its directors, while the other is the essence of frugality.

A fund with high expenses should have trouble matching the return of a competitor with low expenses. So the fund's expense ratio may be a valuable datum in the absence of a long-term track record — especially since a little luck in selecting investments could offset high expenses for a year or two. But never forget that results, not thrift, are the criterion.

I suggest these guidelines regarding expenses:

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[4] The Handbook for No-Load Fund Investors, a yearly publication, provides a wealth of information on over 1,500 funds. You can order it for $49 from the No-Load Fund Investor, P.O. Box 318, Irvington-on-Hudson, N.Y. 10533;

[5] A 12-b-1 plan allows a fund to use a specified share of its assets each year for advertising and other activities to obtain new shareholders. The expense ratio is the fund's annual expenses stated as a percentage of the fund's average yearly assets.

1. If a fund has for many years lived up to its investment objectives, and it has consistently produced a return as good as most others in its class, don't worry about its expense ratio — even if it's conspicuously high.

2. If the fund hasn't lived up to its investment objectives, or if it has consistently underperformed its competitors, don't bother with the fund — even if its expense ratio is very low.

3. If you don't have enough information to use guidelines #1 and #2, then avoid a stock fund whose expense ratio is over 1.5%, and avoid a bond fund or a money market fund whose expense ratio is over 1.0%.

TAXES ARE SECONDARY

Rule #8: Keep tax planning in its place.

If you let tax considerations dictate an investment decision, you might lose more on the investment than you save in taxes.

First determine the best means to satisfy your investment purpose. Then decide how to implement those means in a way that helps reduce your tax burden.

For example, if safety is important, don't let tax considerations lead you to buy a tax-exempt bond fund — which lacks the safety of investing in Treasury securities. But having decided on Treasury securities, invest in whatever way minimizes the tax bite — such as holding a Treasury-security fund inside an IRA (Individual Retirement Account).

Also be aware that funds with similar investment strategies can be quite different in the taxes they generate. Which brings us to the next rule . . .

LOOK FOR SMALL DIVIDENDS

Rule #9: <u>Choose funds that pay the smallest dividends.</u>

Of the funds that serve your investment purpose, focus on those that pay the tiniest dividends. I realize this is opposite to the advice you usually hear, but it makes much more sense.

A mutual fund dividend accomplishes only one thing — to run up your tax bill. The dividend (or capital gain distribution) simply takes money from your left pocket and puts it into your right pocket — with the tax-collector taking part of the transfer.

The dividend adds nothing to the value of your investment, because the money the fund gives you has been taken from the net asset value of your shares — causing the net asset value to drop by the amount of the dividend. Before the dividend, whatever the fund had earned caused the share price to rise, and you could withdraw those earnings at any time just by redeeming (selling) all or some of your shares.

If the fund paid no dividends, you could choose when to be taxed simply by choosing when to sell. Your investment could accumulate and compound for years, if you liked, with no taxes to slow the compounding.

But by declaring a dividend, the fund takes the choice away from you. The dividend is taxable income this year — even if you reinvest the dividend in additional shares.

Why then do funds pay dividends? Because if they don't distribute their investment gains, they have to pay taxes themselves — which would greatly complicate its relationship with its shareholders. So all funds pay some dividends.

However, the tax laws provide ways for a fund to minimize the damage. Unfortunately, many funds disregard those opportunities and pay out more than they need to as taxable dividends, because so many investors have been taught that big dividends are a plus. But some other funds work hard to keep their dividends small. So funds with similar investment objectives and similar performance records may differ considerably in the taxable dividends they pay.

Most tables of mutual funds in The Wall Street Journal, Barron's, or other publications show dividend yields. It's easy enough to find the funds that minimize dividends.

Always choose funds first on the basis of how well their investment objectives and performance match your needs. Among the funds that qualify, buy those that minimize your tax bill by limiting dividends.

DON'T JUMP BLINDLY

Rule #10: Never do anything you don't understand.

The only way you're likely to suffer a disastrous loss is with an investment you don't fully understand.

It isn't sufficient that your favorite advisor, your best friend, or your brother-in-law understands something. It isn't his money that will be lost.

Even if he does risk his capital alongside yours, he may be better suited to take this particular risk — by virtue of his emotional makeup, his financial condition, or his other investments. It's better to leave your money in Treasury bills than to expose yourself to risks you don't comprehend.

Invest in things you understand. Then expand your knowledge — if you want to — to open up more possibilities. But don't be in a hurry. Take your time, and take each step deliberately.

SUMMARY

From these 10 Golden Rules, we can summarize the procedure for selecting mutual funds:

1. Define the investment purpose to be served by the funds you buy.

2. Find the funds whose investment policies match your purpose.

3. Of these funds, narrow the field to those that whose records live up to their policies.

4. Eliminate those funds that don’t stay 100% invested.

5. Of the funds remaining, select those that pay the smallest dividends.

THE PERMANENT PORTFOLIO FAMILY

Terry Coxon created the Permanent Portfolio Family of Funds in 1982 to enable you to employ these Golden Rules effectively.

There are now four funds in the family — each designed to carry out a specific purpose. Each remains fully invested at all times, so a fund manager’s opinions about market trends can’t thwart your objective.

And each fund is alert to opportunities to reduce your tax bill. None of them can avoid paying dividends entirely. But normally each pays a dividend that’s only a fraction of what funds with similar investment policies pay.

Here are the four funds . . .

The Aggressive Growth Portfolio

This fund is fully invested in stocks that tend to outperform a rising market. It is designed to be volatile, and can move dramatically, in either direction.

The Aggressive Growth Portfolio is ideal for the stock-market portion of a diversified portfolio, or for a speculation in stocks when you expect the market to rise.

The Treasury Bill Portfolio

This is a money market fund that invests only in short-term Treasury securities — the safest possible investment in terms of credit risk. However, rather than keep its share price fixed at $1 by paying daily dividends, the fund holds on to its earnings and lets the share price rise. It pays only one dividend a year — a dividend no larger than needed for the fund itself to avoid income tax.

This means a good part of your return escapes taxation until you decide to withdraw the money by redeeming shares. Even then your tax bill may be very low — since you pay tax only on the profit portion of the particular shares you redeem. The rest of your withdrawal is a return of capital.

If you eventually redeem all your shares, you’ll pay tax on all your earnings. But deferring the tax until then can put you way ahead — because, until then, the money not paid in taxes is compounding inside your account.

The Treasury Bill Portfolio is ideal for the dollar portion of a long-term investment portfolio, as well as a safe place to park your capital while you wait for an attractive speculation.

The Versatile Bond Portfolio

This fund is similar to the Treasury Bill Portfolio except for the investments it holds.

Instead of U.S. Treasury bills, it invests in short-term corporate bonds. The high quality of the bonds (rated A or higher by Standard & Poor's) limits the credit risk. And the short time to maturity of the bonds (always 2 years or less) limits the effect of changes in market interest rates on the share price. Thus, without taking big risks, the fund can earn a higher return than with Treasury bills.

The Versatile Bond Portfolio is suitable for the cash portion of a long-term investment portfolio, and it's a good place to keep capital while waiting for speculative market opportunities.

The Permanent Portfolio

This unusual fund was designed to protect you no matter what happens to the economy — prosperity, inflation, deflation, or recession. It holds fixed, unchanging percentages of its assets in:

- aggressive growth stocks (15%),
- shares of real estate and natural resource stocks (15%),
- high-grade dollar assets, such as U.S. Treasury securities (35%),
- gold (20%),
- silver (5%), and
- Swiss francs (10%).

Because bull markets in most investments affect their performance more than bear markets do, at any given time the Portfolio's rising investments can outweigh those that are falling — and so the Portfolio can rise even when stocks or gold is in a bear market.

The Permanent Portfolio Fund is ideal as a long-term investment — to keep a safety net under your investment strategy, whatever that may be. No matter what happens, you'll know that a portion of your assets are completely safe.

Safety & Profit

The funds are the best way I know of to obtain the kind of reliability, opportunity, and tax advantages I've outlined in the 10 Golden Rules of this article.

The minimum investment to open an account in any of the funds is $1,000. You can obtain a prospectus with more complete information — risks, expenses, and services available — by calling (800) 531-5142 or (512) 453-7558. You need to read and understand the prospectus before you invest — as Rule #10 urges you to do.

Whether or not you use the Permanent Portfolio Family, I hope these Golden Rules will help you choose a mutual fund more efficiently.

FORECASTING VS. STRATEGY

March 9, 1980

It is natural for investors to assume that success depends upon the ability to predict the future.

The investor tries to foresee what will happen next year, and bets on his forecast through the investment markets. His profits, he believes, will depend upon the accuracy of his forecast.

Usually, however, he finds that events don't occur in the way he had foreseen. And so he looks for an investment advisor to help him. He reads the advertisements in *Barron's* (or some other journal) – learning of the advisor who correctly foresaw the rise in a particular investment or an advisor who claims to consistently issue timely buy and sell signals.

The investor chooses the most promising advisor and rubs his hands in anticipation of the big profits that finally will be his. Unfortunately, however, he falls prey to a natural law of the investment world:

The advisor with a perfect record will turn sour as soon as you start using his advice.

Interestingly, the advisor will probably continue to advertise his excellent results. And if you check the advertised results against the forecasts he gave, you'll probably have to admit that his advertisements are correct – in fact, if not in spirit.

There are several possible reasons for this. One is that the advisor may have offered many different (and possibly contradictory) forecasts over the past year. Another possibility is that he offered several investment alternatives for taking advantage of a correct forecast, and you happened to select the weakest alternative. Or his triumphant predictions may have been accompanied by a legion of qualifications that made the predictions meaningless. Or the trading advice may have consistently reached you too late to be profitable.

One way or another, it turns out that the highly publicized predictive powers of the advisor have been of no value to you. Even the occasional lucky guess – forecasting the range of next year’s gold prices, for example – doesn’t usually translate automatically into investment profits, because it doesn’t necessarily tell you just when to buy or sell.

An investment advisor’s job isn’t to predict the future. His only future-seeing role is to call your attention to possible events that other people seem to be ignoring. Or to point out why an event that most people are expecting has little chance of coming to pass. But this is quite different from predicting the future.

To be useful, predictions would have to spell out specific dates, so as to facilitate the timing of investment purchases and sales. And the predictions would have to be consistently accurate, because you would be betting on the wrong predictions as well as the right ones.

Such predictive powers are literally beyond the abilities of any human being – and will be seen to be so whenever the full context of past predictions is examined. We live in a world in which any single event is the consequence of millions of causes. And it is beyond the power of any individual to be aware of all the causes – or to have a understanding of all the natural laws that determine what the causes will lead to. And if a large organization is employed to try to gather all the relevant facts, the selection and interpretation of those facts will be confused by a mixture of personal opinions.

So when the investor finally abandons the hope of knowing the future, he unloads a lot of excess baggage. And he may be ready to begin the serious task of learning how to deal with his investments.

But how can he make investments without knowing what will happen to them?

He has to rely upon a proper strategy – a strategy that can produce profits in an uncertain world. And until he abandons the hope of finding an inside track to the future, he'll never do the thinking necessary to develop the strategy.

This article will attempt to provide the principles of such a strategy. It is, in effect, a summary of the philosophy that has been evolving in the newsletter over the past five years, and that underlies the investment suggestions I make.

UNCERTAINTY

Naturally, it begins with the recognition that we live in an uncertain world – a world so large and so complicated that you could never hope to understand completely even the things that are most important to you. Nor could you hope to anticipate every event that will have a bearing upon you life. To expect to do so is to carry the demoralizing responsibility for an unrealistic goal.

EXPECTATIONS

But, while you can't predict the future, you necessarily have expectations. All human action is based upon beliefs and expectations.

You have beliefs concerning the conditions that will bring happiness, and beliefs concerning the way you must act in order to bring about those conditions. And you have expectations concerning the way others will act and react.

Your expectations concerning the world at large might be very general – such as assuming that price inflation won't end this year or that the Russians won't withdraw from Eastern Europe or that Richard Nixon won't be reelected president in 1980. And you may have more specific expectations regarding the directions of the economy, the securities, markets, specific industries, and even specific investment prices.

The first step in investment strategy is to recognize your expectations. The second step is to disregard the expectations that you hold in common with many people. The expectations that match those of the majority should remain in the back of your mind, but they aren't important for investment purposes.

Only the expectations that differ from the majority view can make money for you. Not because the majority is always wrong (it isn't), but because you can't make money betting on the favorites.

OFF TO THE RACES

This would be easier to see if we were betting on horses. Suppose that you study the racing form for the eighth race at Santa Anita. You decide that Spectacular Bid should win the race, you discuss the matter with other bettors, and you find that almost everyone agrees with you.

If that's the case, you'll have to risk $2 in the hope of winning only about 20 cents. And, in an uncertain world, there is no guarantee of success; your horse could break a leg, another horse might have been kept under wraps until now, or it might start raining as the horses leave the post. With such uncertainty, why risk $2 to make only 20 cents?

Suppose, instead, that your studies produce a possible winner that almost everyone ignores. In that case, other bettors (through the pari-mutuel machines) will offer much better odds – 10 to 1 or 20 to 1 or more. A $2 risk has the chance of producing a profit of $40 or more. The bet makes more sense.

Given the natural state of uncertainty, it makes no sense to risk a large amount against the hope of a small profit. Even if you're right a majority of the time, a single loss would wipe out a series of gains.

INVESTMENT ODDS

In the investment world, there is no tote board that lists the loss-reward odds – but the odds exist, nonetheless. They are just stated in a different way.

For example, suppose the price of gold is $700 per ounce today. It means, basically, that the consensus judgment of the potential and actual participants in the gold market (the other bettors) is that the price of gold will be around $800 a year from today.

Today's gold price results from two basic factors: (1) immediate needs – such as the need of a gold fabricator for the metal or the need of a gold miner or gold investor for cash; and (2) expectations concerning future gold prices. If the anticipated future price is enough above the current price to produce a bigger profit than can be earned in a no-risk investment (such as Treasury bills), many professional investors will purchase the gold and take the risk. So a $700 gold price today means that the average opinion of the market's participants is that the price will be about $800 next year. If the anticipated price were higher than $800, more people would buy and push today's price higher; if the anticipated price were lower than $800, too many people would sell, pushing today's price lower, because the anticipated return would be too small.

If you expect a price of $1,000 a year from now, and you feel you can limit a loss to $100 per ounce, it means the market is offering you odds of 3 to 1. If you're right, you'll make $300; if you're wrong, you'll lose $100 – odds of 3 to 1. Or an expectation of a $1,500 price would create odds of 8 to 1 (an $800 gain vs. a $100 loss).

On the other hand, if you expect an $800 price next year (as the majority apparently does), you are getting odds of only 1 to 1 (hoping for a gain of $100 against a risk of $100 per ounce).

By weighing the potential reward against the possible loss, you find the odds that are being offered to you. And it's necessary to do this – in order to identify the loss-reward ratio. A mere expectation that the price will go higher is not sufficient reason for making an investment.

Suppose, for example, that you could find no reasonable way to limit the loss to less that $300 per ounce. In that case, an expectation of a $1,000 price next year would still leave you with odds of 1 to 1 ($300 vs. $300) – considerably different from the 3-to-1 odds you would have if the loss could be limited to $100.

Since you can't predict the future, your expectation concerning next year's prices is only a guess – a guess that you need to make in order to decide whether the investment is worth the risk.

The future isn't assured. But an expected price should be more than just a vague possibility (of which there are billions in this world); you should believe there is a *good chance* of its coming about.

The difference between the "good chance" bettor and the man who "knows" the future is that the former always knows that he may be wrong. And so he pays attention to the loss possibility that's involved, and he finds a way of limit it.

Further along, I'll discuss my method of identifying and limiting the loss. First, however, we should establish a standard for determining whether the odds offered for a given investment are attractive enough to warrant making a bet.

THE RIGHT ODDS

It makes sense to me to invest in something only if the odds offered are 10 to 1 or better. I want the potential reward to be at least 10 times the amount I might lose.

At first glance, this may seem excessively ambitious – or that only the riskiest kinds of investments would qualify. But the loss-reward ratio has nothing to do with the inherent riskiness of the investment – if by riskiness we mean the possibility that all one’s capital might be lost.

When I suggested buying silver at $5.28 in March 1978, the loss was limited to 8% through a stop-loss at $4.88 – while we were hopeful that the price would rise by 100% or more – odds of 12 to 1. On the other hand, if you lend money to your flaky brother-in-law at 20% interest, you’re taking the chance of losing 100% of the capital – odds of 1 to 5 (not 5 to 1). The riskier investment can have the worst odds.

As to the possibility that my standard is unduly ambitious, there are four reasons that I think it is reasonable:

1. *The alternative*: Suppose you decide you’re tired of spending money on newsletters that only make you feel guilty as they pile up, unread, in the corner – and that you’re tired of traveling to investment seminars where you tend to fall asleep during the speeches. Suppose you decide that you’re tired of arguing with your spouse over where your money should be invested – or tired of getting into emotional discussions at cocktail parties over whether gold or stocks are proper investments.

In short, suppose you decide that you’re tired of all the time, trouble, and cost involved in trying to handle your investments. And since hiring an advisor requires the same effort in order to choose wisely, what alternative is left? What would you do with your money?

One simple and safe alternative would be to leave the money in 90-day Treasury bills – instructing the bank or broker to buy new bills as they expire. For at least the foreseeable future, the chances of losing the capital are very remote.

If you do this, you’ll receive interest that’s about 1% or 2% under whatever is the price inflation rate at any time. The inflation rate will fluctuate, but so will the interest rate on the T-bills – since you will get new ones every 90 days.

That might seem to be a losing proposition, but it really isn’t. It would mean that you’re paying 1% to 2% per year in purchasing power to protect your wealth from sudden loss and to accomplish that without any personal effort. Few people begrudge the insurance premiums that are paid and never recovered, so why begrudge the small cost of this easy safety?

Because the 2% is subtracted yearly from a decreasing balance (in purchasing power), it is a form of reverse compounding. So it would take 34 years (not 25) before your purchasing power would be cut in half – and 54 years before it would be cut to a third.

Taxes would affect these results, of course, but they affect all other investments as well. And it might be possible to shelter the investment so that you pay taxes only as you withdraw cash from the T-bill portfolio.

By exercising no investment judgment other than buying T-bills, you can achieve a risk-free return of about 12% for 1980. Therefore, there is no point in bothering with any investment unless there’s a chance to improve upon that.[1]

2. *The losses*: If you do make investment choices, you're bound to have losses along the way.

I have made many mistakes throughout my life. Only ignorance or arrogance could cause me to think that I made my very last mistake an hour ago. There are more to come.

I think that life is simply a process of "growing up," that I will always be learning and improving, and that I will always look back on the previous year with embarrassment as some of the foolish things I did and expected.

That means that some of today's expectations and tactics will also turn out to have been misguided. I will make mistakes; I will suffer losses.

Thus, the winning investments must produce profits that are large enough to compensate for the losses that will inevitably occur.

3. *The effort*: Since investing is not effortless (while holding T-bills is), the profits must be great enough to cover my losses, then equal the T-bill return, and then produce enough more to justify the effort.

4. *The variables*: Lastly, the expected price is only an educated guess. Even if I am generally correct in this case, I don't really know how much profit I'll make. I don't know the precise price at which I'll sell; I don't know what mistakes I might make in buying, selling, or holding the investment; nor do I know if the

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[1] If you were to really consider doing something this simple, there might be other portfolios that would be more appropriate. But the Treasury bill is the classic example of the investment that contains no risk of dollar loss, and thus its return is the standard that any other investment must exceed in order to justify its risk.

eventual sale will be hindered by surprises such as wide price fluctuations, unusually large spreads between buying and selling prices, restrictions imposed by the government or the market, etc.).

Thus, I need the potential of a big profit so that, whatever happens, I'll still have a worthwhile gain (enough to satisfy the first three reasons I've given) after the potential has been eroded.

If the potential profit is 100% or better and my general expectation is correct, I can suffer a few surprises and still come out with a healthy return. But if I start with a hope of only 25%, I have no margin for error.

ABSOLUTE RETURN

A second standard is also necessary. The investment should have odds of 10 to 1 or better, so that the gains will more than cover the inevitable losses. But the investment should also have a potential profit of 50% per year or better – regardless of the potential loss.

For example, a one-year investment that combined a profit potential of 10% with a loss potential of only ½% of the price would have odds of 20 to 1. But the 10% return would be less than the current Treasury-bill return. Even with the low loss potential, what would be the point of making the investment? The potential profit should be considerably better than the T-bill return in order to tolerate surprises and still justify the effort.

If the odds are good but the absolute-return potential is low, the investment can be brought up to the standard by using margin. In the example given, the investment could be bought on 10% margin (leverage of 10 to 1) – thereby increasing the loss potential to 5% and increasing the profit potential to 100%.

So I set two standards for a prospective investment: 1) the potential gain should be at least 10 times the potential loss; and (2) the profit potential should be at least 50% for each year I believe it will take to earn the profit.[2]

LOSS LIMITATION

I suspect that the failure to develop an effective method of limiting losses is the single largest contributor to poor investment results.

Some people ignore the downside risk entirely. I have often heard an investor say that he "thinks positively" about an investment. And if he things the price is going upward, why muddy one's confidence by dwelling on the downside potential?

Obviously, that attitude is wrong. And it's amazing that no accumulation of losses will stop the investor from "thinking positively."

But it isn't much better simply to acknowledge the downside possibility and promise to "sell if the price drops." The word "drops" is meaningless in this context. The price might drop by 0.0003% two minutes after you buy; would that mean you should sell? How *far* must the price drop to warrant getting out?

It's obvious that you must know – *before you buy the investment* – exactly how far you'll let the price drop before selling.

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[2] If the time span of the investment exceeds one year, the 50%-per-year standard should be compounded, not simple multiplied by the number of years anticipated, in order to equal the potential of separate one-year investments. That is, a project two-year investment should have a potential profit of 125% (not 100%) – increasing the capital from 100% to 150% the first year, and from 150% to 225% (a gain of 50% on the 150%) the second year. Similarly, a projected three-year investment should have a potential profit of 238% (not 150%), and 400% (not 200%) for a four-year investment. In a long-term investment, it need not be assumed that the price will increase by 50% every year, only that the overall result will be equivalent to that.

This decision must be made before the investment is purchased, because your emotional state will change as soon as you make the purchase. When you don't own an investment, you can look at the matter objectively. But once you've bought it, you have an emotional interest in its success – and that can inspire you to hang on in the hope of an imminent recovery.

The reluctance to take a loss is one of the most significant barriers to investment success. And so it is foolish to believe that you can make decisions as effectively while you own the investment as you could before you bought.

Stop-Loss Orders

When you've decided how much you're willing to lose, you should enforce the decision by issuing a stop-loss order *at the same time you issue the instruction to buy the investment.*

Without a stop-loss (an instruction to the bank or broker to sell the investment automatically if the price drops to a specified level), you are prey to the emotional turmoil that leads to so many losses. During a falling market, you must reopen the question daily – the question of whether to sell or to hold on a little longer.

And no matter how great the loss at any given point, the answer 99% of the time will be to hold on. It will almost always seem to make more sense to wait before selling. After all, the price might rise tomorrow – and another day's price drop will not, of *itself*, be fatal. No one day ever seems to be critical. And so the separate, non-critical days add- up – along with the losses.

Consequently, you are likely to take the initiative to sell only when frightened into doing so by the very conditions that usually accompany the end of a downtrend – large daily price drops, panic news, or widespread margin calls. And so you can wind up selling at the very bottom, simply because you hadn't given authority (through a stop-loss) to your earlier decision to sell at a higher price.

Options

A second way to limit losses is by using options. If you purchase an option, the price of the option itself constitutes the maximum loss, since you aren't liable for anything but the option's cost. And you can't usually limit the loss to anything less than that; option prices fluctuate too broadly to permit a stop-loss.

Other Situations

There are situations where neither stop-losses or options are possible. These include illiquid investments such as real estate, collectibles, and business enterprises. In such cases, it is difficult to know even the value of the investments at any given time.

To compensate partly for this, I think it's valuable to identify (at the time you make the investment) the conditions that might occur that should prompt you to sell the investment. Make a list of the various economic conditions that would confirm the idea that the investment is now a mistake to hold. These might include falling prices of related investments, changes in certain national economic indicators, changes in the economic climate that surrounds the investment, etc. Review the list periodically to see if the investment still makes sense.

Of course, this is a far cry from having a stop-loss – but it is much better than failing to define the rationale behind the investment. The lack of such mechanisms as stop-losses and options is one reason that I am very cautious about illiquid investments – and that I believe they should be limited to only 15% to 20% of your total wealth.

However, you might decide to purchase an illiquid investment on the basis that you're willing to lose the entire amount. As long as you're really prepared to lose it all, it's obvious that you've decided to get out of the investment, if it does poorly, only when its value falls to zero. So no further consideration of when to bail out is necessary.

Permanent Portfolio

Permanent Portfolio (long-term) holdings are usually exempt from the stop-loss rule. For one thing, there are usually time limits on stop-loss instructions. For another, long-term holdings are, by definition, not selected because of current market trends.

Here again, however, I think it's valuable to identify and write down the reasons behind each investment – and to specify the conditions that would confirm that the investment is no longer a good choice.

PROFITS

As I said earlier, small profits won't serve to cover your losses nor will they justify the effort involved in investing. But, again, a mere admonition to "let your profits run" has no more substance than a promise to "sell if the price drops." In each case, one must have a systematic way of identifying precisely the conditions for selling.

The original analysis of the investment provides a rough price objective. But this isn't really a forecast of where the price will peak. It is only an assessment of a price you believe is reasonably possible, given your analysis of current conditions. Its purpose is to determine the general *magnitude* of the profit potential – so that you can decide if the loss-reward ratio meets your standards.

To decide in advance that you'll sell when the price rises to that objective could cause two problems. The first is that the price may get close to that objective, but never quite reach it. If the price then falls all the way back to the original stop-loss level, the earlier price advance will have netted you nothing.

The second drawback to setting a selling point in advance is that the price may go way beyond it. Since the investment strategy maintains that a few very large profits are necessary to justify the effort of investing, taking profits at prices too low can defeat the purpose. In 1978, with silver at $5 and gold at $170, who would have set 2-year price objectives of even $20 for silver or $500 for gold – let alone the peaks that they've reached so far?

There's an old saying that "no one ever lost money taking a profit" – meaning, roughly, that selling too soon and taking a profit is better than selling too late and taking a loss. This may be true if you consider only the transaction at hand. But if you consider a series of transactions, people *do* lose money by taking small profits – because their profits are never big enough to offset the losses that inevitably occur. The final result is a net loss overall – and the overall results are what count, not the result for any one transaction.

So, when you catch that sought-after long uptrend, you don't want to be bound to a specific price objective that could cause you to sell much too early. And you don't want to be bound to a specific price objective that could cause you to wait too long if the uptrend turns out to be short-lived.

There are a number of technical tools available for identifying the tops of uptrends as they occur, but I have never found any of them to be reliable (and I have spent a good deal of time investigating them). As examples, the gold and silver markets have defied almost all the tried-and-true technical indicators during the past few months.

Stop-Losses Again

The answer, of course, is to find the best way possible to let the market tell you when the uptrend is over. You can do this by raising the stop-loss as the price increases – finally selling whenever the price has dropped far enough to trigger the current stop-loss. You won't sell at the very top this way, but no one you know will do so either.

When choosing a stop-loss, the object is to pick the level that will cause a sale if there is confirmation that the trend has ended, but will keep you in the market as long as the uptrend is still alive. Thus, we can define an *efficient stop-loss price as: the highest price that would indicate that the investment is not now in an uptrend*. At the time of the purchase, the efficient stop-loss is the price that indicates that the purchase was a mistake; later (after a price rise), it is the price that indicates that there's no more profit to be had from the investment in the near future. In all cases, you want the highest price that gives these signals.

Finding the efficient stop-loss level is no easy task. It isn't enough to decide how much you're willing to lose and place the stop-loss accordingly. This could cause you to lose more than necessary or to sell out just before the price finally moves upward. However, in the absence of any other basis for choosing, it would still be wise to place a stop-loss a little above the price level that represents the maximum you can afford to lose.

The basis of my system for picking stop-loss levels was explained in *New Profits from the Monetary Crisis* in chapters 8, 9, and 29. I have augmented those ideas in the article, "Finding & Using the Efficient Stop-Loss," which immediately follows this article.

Bear in mind that no system of picking stop-loss levels will ever be perfect. Sometimes, the uptrend will resume immediately after the stop-loss has been activated. The object is to create stop-loss levels that correctly confirm trend changes *most* of the time – but you won't be right every time.

Nevertheless, you're still much better off than if there were no stop-losses at all. The stop-loss is simply a concrete manifestation of your estimate of what constitutes a change in trend. You would be subject to the same mistakes in estimates if you didn't use stop-losses – but you would be without the protection stop-losses provide.

OPTIONS

Purchasing an option and letting it sit is an exact counterpart of setting an original stop-loss but never raising it. If the price rises substantially but then falls back to where it started (all within the time period of the option), you will not have profited from the price rise.

If the price is higher at the time the option expires, profits will be locked in by selling the option and replacing it with a new one. The new option will necessarily have a higher striking price – and, thus, will have less value than the option you're selling. Thus, the new option will cost less than what you receive for the old option; the difference represents profit that can be banked - never to be given back to this market. In the absence of a better system, one can decide merely to continue rolling over the options in this way until such time as an option expires with no value – and consider that to be the end of the investment.

However, there might be a strong price rise followed by a fall - within the life of one option. To wait for the expiration date before acting can mean losing a good deal of the potential profit.

To remedy this, you can sell the option prematurely (before expiration) if the price goes up by a significant amount – replacing the option with a new one that has a higher striking price and a lower cost. Again, you lock in interim profits as they occur – before they slip away from you.

Whenever you replace an old option with a new one, you pay a cost for the privileges that an option provides – and part of that cost is nonrecoverable. Thus, it can be too expensive to replace the options too frequently. As a result, you should decide at the outset how much profit should accrue in the option before rolling it over.

And if a given option expires with no value, you can take that as a signal that the investment is over.

EARLY SALES

These procedures, with stop-losses or options, are designed to implement the adage, “Let your profits run,” without forcing you to pick a selling price in advance – and without the agony of reopening daily the question, “Should I sell?” You can relax and let the sale occur automatically when the time arrives.

However, there are times when it makes sense to make a deliberate decision to sell “at the market” (the current price), even though a stop-loss hasn’t been triggered. This is partly because of an easily overlooked, but important, principle: *The price at which you bought is no longer a consideration in deciding whether to sell.*

I’ve mentioned often that you shouldn’t wait for the price to return to your buying price before liquidating an investment that has gone wrong. In the same way, if you’re in a profit position, you shouldn’t let the buying price influence current considerations. In either case, it helps to look at an investment you already own in the same way that you would look at a prospective new investment.

In deciding what to do with a winner, you should look only at the present price of the investment – not at the price you paid. The investment’s present value is part of your current net worth; any erosion of the investment’s value (through a price drop) is an erosion of your net worth. The erosion won’t be eliminated by saying that you’ll still wind up with a good profit on this investment.

For example, suppose you bought an investment at a price of $100, and the price has risen to $200. You could take the attitude that a drop to $150 wouldn’t hurt you, because you would still have a 50% profit.

But a drop to $150 will mean a loss of 25% from its present value. And you probably wouldn't enter a new investment if the loss potential were 25%. An existing paper profit shouldn't cause you to relax your loss-limitation standards. Neither should an existing profit allow you to lower your standard in evaluating the potential reward that remains in the investment.

Suppose that you see the potential peak to be $250. This represents a reward of only 25% from the current price. If, for some reason, the efficient stop-loss level must be $150 (a drop of 25% from $200), the market is offering you very poor odds (1 to 1) for holding the investment further.

You could say, "If the price goes to $250, I'll have made 150%, and the worst that can happen is that I sell at $150 for a 50% profit, so why not try for the $250?" But the profit potential from the $100 buying price no longer applies, because that prices is no longer available to you. The present price is $200 – and only the potential loss and reward from that level are important now.

Given these principles, I can think of three types of situations in which it might be better to sell outright, rather than waiting for a stop-loss to be triggered.

VOLATILE MARKET

The first situation is the extremely volatile market. If the price is subject to large changes within one day – say, 10% or more – the risks in holding the investment are especially great. The price could drop so far between one day's closing and the next day's opening that a stop-loss sale would occur at a price far below the stop-loss instruction. Realistically, you would have to consider the potential loss (from the current price) to be greater than just what the stop-loss level suggests.

Recognizing this, you might decide to sell outright – rather than risk having the stop-loss prove to be ineffective. Another alternative, however, is to sell a part of the investment – one-half, perhaps – and let the stop-loss cover the remainder.

Low Efficient Stop-Loss

The second situation occurs when the efficient stop-loss level is not close enough to the present price to be useful. A rapid increase without the normal periodic retreats can cause this problem, and it usually means that the price is capable of a long drop without ending the uptrend. If the efficient stop-loss level is 20% to 40% below the current price, you're in trouble. To allow the price to drop that far is to allow too much erosion from the present value of your portfolio; but to place a higher stop-loss is to risk being sold out before the uptrend is really over.

Again, the answer may be to place a stop-loss on half your holdings at the efficient stop-loss level, with a stop-loss on the other half somewhere between that level and the current price.

Another alternative is to sell all your holdings, with the intention to rebuy if and when the price rises or falls to a level where the efficient stop-loss is more useful.

Both of these abnormal situations are more likely to occur toward the end of a trend; earlier phases are usually more orderly. So a deteriorating loss-reward ratio may induce you to sell all or most of your holdings. If the price should then go higher, the fact that you already had a good profit might make the sale emotionally easier to tolerate.

The gold market was in both these "possible sell" situations recently. The price was very volatile – moving as much as 15% in one day. And the run from $600 to $850 was pretty close to a straight line, leaving the efficient stop-loss level at $565, or 34% below the top. I chose the alternative of a stop-loss on half the gold at $675 (around halfway down) with the rest covered by a stop-loss at $565. Given the same circumstances, I'm not sure I'd handle it the same way again.

Alternative Investment

The third possible sell situation occurs when another investment is more attractive. Suppose that you bought an investment at $100, with a potential peak of $300. When the price has risen to $200, the efficient stop-loss happens to be at $175 – limiting the downside potential from the current price to 12 ½%. But suppose that you see another investment, also priced now at $200, with the potential to rise to $400 – a potential gain of 100%.

You might say that the earlier investment is superior because it had a potential for 200% profit – half of which you've already earned. There would be a natural bias for holding the present investment, rather than switching.

But, again, all that matters is where you are now – not where you started. Imagine that you don't hold either investment; which one would you buy? They each cost $200, but one has a potential of $300 and the other $400. If the potential loss is somewhat the same, the answer is obvious.

It's obvious partly because both are priced at $200 in the example. In practice, they'll have different prices, and so the potentials must be translated into percentages. But the principles the same: look at the present investment in terms of its current price, not the price you paid for it. From this point onward, which investment offers the better prospect?

In any comparison of two investments, you may decide to choose the one with a smaller potential if the probability of its realization seems greater. And this can often be the investment you already own and which is rising. This is because the present investment has already established an uptrend – while the other investment, although it may have great potential, might not yet have proved that its uptrend is for real. The time to switch may come later, after the second investment has proven that its time has come.

Each of these three situations (an overly volatile market, difficulty in finding an efficient stop-loss level, or a more attractive alternative investment) can be a reason for selling all or part of an investment before a stop-loss is triggered. But I wouldn't sell an investment just because I thought it might be near its peak. As with any other forecast, this kind of fortune-telling is as likely to be wrong as it is to be right. I'd wait for the stop-loss to be activated.

OTHER MARKETS

At any time, there always will be a number of stocks, commodities, and other investments that are moving upward. This can cause you to feel that you aren't getting in on all the action. In fact, some of these other investments are bound to be showing bigger profits than the ones you hold. It can be difficult to keep your perspective.

Realize that you can't stay on top of every conceivable investment; to even try to do so would be a big mistake. No one person has the time to follow the fundamentals and technical indicators on every market. And if you delegate part of the job to others, you'll often receive analyses that aren't consistent with your view of the world.

Therefore, the investments outside your sphere of interest are not missed opportunities; for you, they never were opportunities. They are outside of your world. Don't kick yourself for not having recognized them.

It's best to try to concentrate on a few groups of investments – areas that you find interesting and relatively easy to understand. If these groups are not too similar, there almost always should be a recognizable opportunity in at least one of them.

If you try to follow too many groups, you may fail to recognize any good opportunities – because your interest will be spread too thin.

Even if someone has recommended an investment just prior to its big move upward, don't kick yourself for not having bought it. You heard at least ten other recommendations at the same time – recommendations that wouldn't have paid off. How would you have known which was the right one?

Realize that there are risks that you're not prepared to take – risks that other people ignore. In many cases, as it turns out, the risk didn't materialize into a loss. But the risk existed, nevertheless, and you were wise to recognize it and to be cautious. You can't analyze an investment and its risks in retrospect; you have to look at the considerations that were present at the time you had to make the decision.

If others take risks that are too much for you, don't be shaken by the profits they may achieve. Perhaps the risks will become relevant tomorrow and destroy the types of investments that currently seem profitable. As the old Greek proverb puts it, "The hare may break his leg on the last lap, causing the tortoise to be glad that he didn't grow long ears" – or something like that.

Be willing to investigate the methods and markets of people who seem to be doing better than you are, but don't feel compelled to jump on any bandwagon.

ADVICE

Remember, too, that the recommendations of professional advisors reflect their own biases, their own emotions, and their own ambitions – which are not the same as yours. Don't be stampeded into joining any trend. No advisor is going to assume the responsibility for your emotional state, your goals, your fears, or your losses.

Even if his viewpoint seems to be roughly the same as yours, don't be panicked by urgent calls to action. If you have set aside a core of your wealth in a way that you think is safe, you're not compelled to react to a prediction of an imminent event. Most alarms prove to have been unnecessary. Changes in your approach, your methods, and your safekeeping procedures should be made only with due deliberation.

TAKING THINGS FOR GRANTED

Lastly, don't take anything for grated. Don't assume that the paper profits you have now are the final result and can be committed to something else before they're realized. Don't assume that the markets will be open tomorrow, that the rules will remain the same forever, that the government will allow you to profit when your expectations come to pass, that a paper IOU you hold (from anyone) will be paid off. Don't assume anything.

If you don't take anything for granted, you'll want to be as diversified as is practical within the range of your expectations. If you hold gold, for example, you might have some gold coins in your own possession and some gold bullion in Switzerland. You'll look for ways of neutralizing the risk in any long-term investment through diversification. You'll be careful never to rely solely on the integrity, talent, efficiency, or durability of any one source.

FORECASTING VS. STRATEGY

We act on our expectations of the future. But to confuse expectations with certainty is the road to disaster. Humility is the realization that you don't know everything, or even everything about any particular thing, and it is an investor's most vital asset. Arrogance eventually ruins any investor – no matter how well he'd been doing.

Once you get beyond the feeling that you must be able to predict the future, you can get down to the serious business of investing in a realistic manner. Since you can’t predict the future, you’ll develop a strategy that allows you to deal successfully with an uncertain world – a strategy that recognizes your own weaknesses and emotions, as well as your ignorance.

Look at your expectations. Challenge the premises on which they’re based. Be sure that this is what you *expect* to happen, rather than what you *want* to happen. Make sure that you are not simply going along with an ideological or investment slogan that hasn’t been analyzed for accuracy. Make sure your expectations are sensible – not certain, just sensible.

Sort through your expectations. Find those that differ from the common view and can be bet on in an investment market.

When a news event seems to be significant, don’t get carried away. Act upon the event only when you interpret its significance in a different way from other people. If your reaction is the same as that of others, disregard it; it’s not worth betting on.

When you identify a unique expectation, look for the investment medium that most precisely matches your expectation. For example, if you believe the price of gold is going up, buy gold. On the other hand, buy a South African gold stock if you think the price of gold is going up and the cost of mining won’t go up proportionately and the South African government will allow the gold mines to profit from the price increase and the particular company will manage its affairs efficiently and there’s little chance of labor problems or natural disaster. If you don’t have expectations about all these things, you shouldn’t buy a gold stock. Match the investment to the expectation as precisely as possible.

See what odds the market is offering you. Is the loss-reward ratio worth acting upon? Do you have a reasonable chance of earning a profit that's 10 times greater than what you'll lose if you're wrong? Is the profit potential at least 50% for each year you'll probably have to hold the investment? Will the capital itself be relatively safe from confiscation, default, or other hazards?

If, at the moment, the loss-reward ratio isn't favorable, keep your eye on the investment. Perhaps its price will rise or fall to a level where it is possible to intelligently limit the loss potential to a smaller amount. Find the point of entry (the buying price) where the loss potential is minimized.

Before you purchase the investment, pick a stop-loss level that makes sense to you – and make sure the stop-loss accompanies your instructions to buy. An idea of where you'll sell is worthless until it is a specific stop-loss instruction that someone else will act upon without consulting you.

Don't be afraid to take a loss if the price goes against you. The man who has never taken a loss is the man who still owns the 40-year bonds he bought in 1960. Small losses are the price you pay for the big profits you hope to get. They are inevitable. The object always is a net profit for the total portfolio, not a win on every transaction.

If the price goes up, don't grab a small profit and run. It is better to allow a small profit to evaporate in a price drop than to miss the opportunity for the large profit that prompted you to make the investment.

As the price rises, raise the stop-loss level. Try to find the level that, if triggered, would be confirmation that the trend is over, but that won't be triggered as long as the trend remains alive.

Keep your head, and don't panic when you see what other people are doing. If their actions are different from yours, good; you can't make money doing what everyone else is doing. Even when they profit, don't feel remorse that you didn't venture beyond your own abilities.

And if you never take anything for granted, you'll remain skeptical about the easy possibilities that others are touting, you'll keep your eyes open for the things that may go wrong, you'll be diversified enough to prevent any single disaster from being a catastrophe.

LEARNING ABOUT YOURSELF

You'll find that your strategy (whether you use this one or one you develop yourself) won't be fool-proof. *No* strategy will be fool-proof. Stop-losses will be triggered, followed by higher prices. Things will happen that you never considered. You'll spot mistakes in your strategy that you'll think should have been obvious to you before.

Try not to reproach yourself for your mistakes; they are as inevitable as the small losses. Try to acknowledge them as soon as they surface – and learn from them. Revise the strategy to incorporate what you've learned.

Life is a process of growing up. The more we grow up, the more successful we are; but we never arrive at a level where there's no more growing-up to be done. So don't reproach yourself for not having been all grown-up yesterday. And recognize that, no matter how smart you are today, you're not going to look as smart from tomorrow's perspective. Today's smart move may be just one more mistake when reviewed tomorrow.

Investing is an aspect of life. You have to live by the same rules as in any other part of life. And in your investment actions you express the same emotions, the same weaknesses, and the same strengths.

Because the investment world is generally more intense and moves faster than other areas of life, it is an opportunity to see yourself in action more dramatically. You can learn a great deal about yourself by watching the way you deal with your investments. You'll see how you react to problems, how you deal with uncertainty, how able you are to act upon what you believe.

As you spot your weaknesses, you can find ways of offsetting them – even if you can't eliminate them. And if you generalize on what you discover about yourself and your methods, you have the opportunity to apply what you learn to other areas of your life – ways of making decisions, methods of dealing with weaknesses or uncertainty, and areas of strength.

After all, what I have been trying to formulate in this article is the same as a guide to living: Admit your mistakes and pay your losses so that you can get a fresh start; make sure your goal is high enough to be worth the effort; develop a way of life that suits your nature; be skeptical about what others say would be good for you; stay with a good thing as long as it pays off.

FINDING & USING THE EFFICIENT STOP-LOSS

March 9, 1980

An important part of the investment strategy involves locating the efficient stop-loss level – the highest price that indicates that the investment is not now in an uptrend.

Almost any stop-loss is better than no stop-loss at all. But the more proficient you are at choosing stop-loss levels, the better will be your overall investment results.

SUPPORT & RESISTANCE LEVELS

It is assumed that an investment price will both rise and fall, even in the midst of a trend that is clearly upward or downward. But a fall through certain price levels can be a signal that an uptrend is probably over.

Such a level is referred to as a *support level*. Heavy buying will occur whenever the price drops to a support level, thus halting a decline. If the decline does *not* stop at that level, its failure to do so is an indication that the relationship between buying power and selling power has changed – and that a major downtrend may have begun.

The standard for choosing a stop-loss price is to locate the support level nearest to the current price.

The stop-loss is then placed about 3% below that level (to provide a margin for error). During a normal fluctuation, a price decline will halt above the stop-loss, leaving you in the market. But a major downtrend will trigger the stop-loss, getting you out of the market before the price drops too far.

Support levels are also resistance levels – prices at which major selling will occur whenever they are approached from below. A price moving upward will stall (or run into resistance) at about the same level where it would stall if approached from above. For example, if $50 is a support level that tends to stop a decline from a higher price, it should also be a resistance level that would halt a rise from below.

Support-resistance levels are created by the actions of investors and other participants in the market. In the commodity markets, a support level is often created because many consumers of the commodity find it to be a price at which it is practical and economical to buy. And resistance levels are often points at which it is profitable for producers of the commodity to sell.

In addition, habitual investor patterns of buying and selling create support and resistance levels. Some of these patterns are explained in chapters 9 and 29 of the *New Profits* book.

The support-resistance levels will be unique for each investment. To locate them, you need to study a price-history graph of the investment. Look for price levels where price rises and declines have stalled in the past; the more often a price has stalled at a given level, the more reliable that level can be considered to be.

For some investments, the support-resistance levels will be obvious; for others, they will not be. When you are choosing among investments that each have an attractive profit potential, it makes sense to choose the investment for which the support-resistance levels are more clearly defined.

ENTRY POINTS

Trends usually unfold in waves – much like a process of advancing two steps forward, retreating one step backward, and then advancing again.

Suppose, for simplicity, that the support-resistance levels for a given investment are at multiples of $10 -- $50, $60, $70, $80, $90, and $100. In a classic uptrend, the investment would rise to about $70 (a resistance level), retreat to $60 (the nearest support level), rise through the $70 resistance level and on up to $80 (the next resistance level), retreat to $70 (now the nearest support level), and then continue upward to $90, etc.

Suppose that the current price is $68. Even if you expect the price to go much higher, it would be a mistake to buy at $68. Why? Because the price is just under a resistance level and quite far above the nearest support level. The efficient stop-loss would be $58 (3% below the $60 support level), which is 15% below the current price of $68.

You're better off by waiting to see if the price is going to make it through the resistance level in this wave or if it will retreat back to the support level. If it retreats, you can buy closer to $60; the efficient stop-loss, still at $58, will limit your potential loss to less than the 15% that was the case at $68. If, on the other hand, the price goes up from $68, you're still better off waiting until the price has reached $72 (about 3% above the $70 resistance level), at which point the efficient stop-loss will become $68 – only 6% below a buying price at $72. Thus, in this case, it is safer to buy at $72 than at $68; the potential loss can be limited more efficiently.

At any given current price, the loss-reward ratio may be uneconomic. But this might change as a result of either a price drop or a price rise. The loss-reward ratio will be the most favorable when the buying price is just above a support level, and the least favorable when it is just below a resistance level.

NEW GROUND

No support-resistance levels are identifiable in ranges where the price has never been, since the levels can be identified only from past stalling points. You can always find the nearest support level in an uptrend, but you may not know where the next resistance level will be.

Some technical systems claim to be able, through measuring devises, to pick price objectives and resistance levels in uncharted ranges. But I have not found these devices to be satisfactory.

HELP

Locating the efficient stop-loss isn't the kind of job every investor is suited for – which is why we frequently suggest stop-loss levels in this newsletter (along with providing investment ideas, locating new investments, and puncturing balloons). As pointed out in the preceding article, we can't expect to be correct every time. But if we pick the right stop-loss levels a majority of the time, the overall results will be profitable.

THE THEORY OF CONTRARY OPINION, R.I.P.

February 9, 1984

One interpretation of the Theory of Contrary Opinion says, "If a majority of investment advisors are in agreement about something, they must be wrong; the object of their agreement must be past its peak and on its way out."

If that's true, the Theory of Contrary Opinion itself must be on its way out. And that will be a relief. It seems sometimes that every advisor in the world is leaning on Contrary Opinion to justify his viewpoint.

While there are aspects of the Theory that make sense and can be helpful, its widespread "use" has become silly.

Supposedly, the price of an investment will move in the opposite direction from that expected by a majority of advisors. As a result, many advisors justify their opinions by saying that the majority of advisors are on the other side of the fence.

I often see two opposing opinions on an investment within the same day – each justified by the claim that the writer's opinion is opposite to that of the majority of advisors. No matter what an advisor's position, he's always in that lonely, independent minority that's the home of all great thinkers.

Perhaps the most interesting aspect of the TCO (Theory of Contrary Opinion) is that I've never seen anyone make a decision based on it. Have you ever seen an advisor write something like:

> As you know, I was bullish on gold [or whatever] in the last issue. But now 80% of the advisory services are bullish, and so gold must be headed downward – and I'm turning bearish.

I've never seen anyone say that. The Theory of Contrary Opinion is invoked only to justify a position already established. In fact, I have read statements such as:

> The only negative in the bullish picture is that the latest reading of advisory services shows that 80% are bullish. This is reason for caution. But since all the rest of our indicators point upward, we're going to plunge in and buy. We'll keep an eye on the bullish consensus, but as of now it appears to be an aberration.

In other words, the TCO is important to an advisor only when it confirms what he wants to believe anyway.

THE LOGIC IN THE THEORY

As I understand it, the original TCO could have been stated as:

> If most people are bullish, we can assume that almost everyone who is inclined to buy has already done so, leaving very little new buying power left to move the price higher. Conversely, if most people are bearish, then everyone who is included to see probably has done so already, and there should be no further downward selling pressure on the price.

This makes sense. However, there are many principles that make sense but are unusable because there's no way to obtain the data necessary to apply them.

For instance, inflation (or the absence of it) results from the interaction between the demand for money and the supply of money. Unfortunately, there is no way to measure the demand for money – except long after the fact. Consequently, one can *understand* the supply-demand principle, but can't *apply* it to anticipate future inflation.

In the same way, it makes sense to "buy when blood is running in the streets" because the outlook for a given investment should never be worse, and so the price may never be lower. But what journal publishes an accurate measurement of the level of blood in the streets?

And perhaps, it's true that major trend reversals occur when the public is overwhelmingly bullish or bearish, but we have no infallible way to know at any time *how* bullish or bearish the public really is. We can only guess. And our guesses are likely to be influenced by what we want to believe.

Even if we really knew, it wouldn't be enough. What we actually need to know is how much *buying power* is still available for an investment. For example, if 80% of the public are bullish, it might be that the 20% who aren't yet bullish have 60% of the investment funds at their disposal—and so represent large, as yet untapped, resources that might still push the price a good deal higher.

Although Barron's publishes a great many indicators, it doesn't offer one that says, for example:

> 35.4% of the adult population, with 29.6% of the available investment funds, are bullish on gold; 64.6%, with 70.4% of the available funds, are bearish.

CONTRARY OPINION INDICATORS

To compensate for this lack of data, various indicators have been created by which investors hope to measure public opinion.

The most popular proxy has been the measurement of advisors' sentiments. Someone reads a lot of investment newsletters and monitors the recommendations of large brokerage companies – using what he finds to construct an index of advisory sentiment. This will be reported as, say, a "60% bullish consensus on stocks" – meaning that 60% of the advisors expect stocks to go up.

One might consult such an index, believing that at a given level of bullishness – say, 70% or more – an investment must have peaked because almost everyone who could buy has already done so. But, unfortunately, an index of advisory sentiment is pretty meaningless.

What advisors appear to be recommending is in no way a confirmation of what investors have done or are doing.

For one reason, the advisor's customers might not do what he recommends. Numerous subscribers have told me they read my "Farewell to Silver" article in 1980, but many of them said they held on to their silver after reading the article. And yet any index of advisory sentiment that included me as a component would have registered me as bearish in January 1980.

For another reason, at any given time, people might be bullish but might not have bought yet. I haven't denied the bull market in stocks, but I also haven't made a suggestion to buy stocks for the Variable Portfolio. I can't be listed among the bears, but none of the buying power I may represent has been used up.

For still another reason, many people don't always act in accordance with their stated opinions. I've met a lot of hard-money investors who say the banks aren't safe but who still have their money in money market funds that are heavily invested in bank CDs.

And for one final reason, people can be bullish and more bullish and even more bullish. I know a man who had been invested in silver for years, but who borrowed money from his bank to buy even more silver on the day it hit $50. By any standard, he would have been counted as "bullish" for a long time before that day, and yet he managed to come up with the buying power for even more silver.

The Best-Seller Indicator

Another contrary-opinion ploy that surfaces from time to time is the best-seller-list indicator. Any time an investment book shows up on the best-seller lists, assume that the investment it's pushing is about to peak and fall.

I recently saw a newsletter article pushing this old superstition as though it were a brilliant new discovery. Maybe it *was* to the author of the article.

He recited the history of investment best-sellers from Adam Smith’s *The Money Game* in 1968 to John Naisbitt’s *Megatrends* in 1983. But to make history confirm his point, it was necessary to distort the contents of some of the books he cited (books that were in fact giving timely and correct advice), and it also was necessary to overlook a number of other best-sellers that happened to be saying the right things at the right times.

As with all the really great technical indicators, a guru is needed to decide which best-sellers are indicators and which should be ignored – and, too often, even the guru can’t do that correctly until years after the fact.

Other Indicators

Another supposed indicator is to watch the covers of the news magazines. When *Time* or *Newsweek* has a gold bar on the cover, you supposedly know that the bull market in gold is over. Cute, but unfortunately not infallible.

Still another indicator is the measurement of the cash positions of mutual funds. If mutual funds have less than, say, 5% of their assets in cash, they have little left with which to push up stock prices. If they have 10% or more, perhaps they’ve sold all the stocks they’re going to sell – and their 10% cash position is buying power that can cause the market to rally.

This indicator is the closest to being useful, because it actually measures money – not presumed opinions. But this indicator has problems, too: mutual funds aren’t the whole market, fund managers can decide to increase their cash holdings to well beyond 10% (to

100%,in fact), and some of them use margin so that a small cash position doesn't mean that their buying power is exhausted.

Unfortunately, there's no way to know whether the public is overwhelmingly bullish or bearish about anything.

THE THEORY PERVERTED

As I said, I believe the basic idea behind the Theory of Contrary Opinion is correct – even if it seldom can be implemented.

But, as with any theory, this one has been corrupted over time by people who can't understand the reasoning behind it, by people who want everything to be simple, and by people who want to use it to justify a point of view. The most popular corruption has been the simple-minded attitude that *the public is always wrong*.

The article on best-sellers contains such a premise: ". . . a universally accepted view about the business or investment outlook will be wrong. In other words, adopt a different or 'contrary' view when opinion is extremely one-sided."

But *why* must the majority always be wrong? Unfortunately, if you ask this, the answer usually is a mystical quote from some great thinker about the loneliness of creation or "the man who stands alone," but no logical reason that the majority must always be wrong.

The truth is that the majority isn't always wrong (or right). A one-sided majority of people believe the earth is round. An overwhelming majority of Americans believed throughout World War II that America would win the war – and they made their business and investment plans accordingly. And it looked to me throughout the second half of 1982 that most investors believed stocks were in a bull market – and they were right.

Importance of Majority Opinion

The importance of knowing the majority's opinion has been perverted by the TCO advocates. It isn't that the majority is always wrong. It is that you can't make large profits betting with the majority.

If the majority believes stocks are going higher, it doesn't necessarily mean they're going lower; it means only that prices are already so high that you can no longer buy at bargain prices. You will bet a lot to make a little – when you should be in the position of risking a little in the hope of making a lot.

For example, in 1981, I tried to point out that the "beat inflation" strategy of borrowing money to buy tangible assets (like gold) couldn't be as useful in 1981 as it had been in 1971 – because, by 1981, what you knew was also understood by everyone else.

You'd be betting with the majority. You'd be buying gold at $500 instead of $35, and you'd be paying 18% interest instead of 8%. The majority might have turned out to be right in their inflation expectations of 1981. But had that happened, you'd have made only a little from being on their side – while risking a great deal.

In other words, inflation hedges are valuable to own only when very few people believe inflation is coming.

So it's important to be sure that you aren't betting with the majority when you're speculating. But that's quite different from assuming that the majority is always wrong.

Snobbery

For some reason, many otherwise humble people give vent to a terrible snobbery when they approach investing.

Advisors and investors love to believe that they are members of a small elite of wise, savvy insiders – while the majority of investors are dumb sheep who know no better than to follow the crowd off the edge of the investment cliff.

The Perverted Theory of Contrary Opinion appeals mightily to this snobbery. It's wonderful to believe that the majority is always wrong – and that you're always on the other side for the majority.

CONCLUSION

The Theory of Contrary Opinion is just one more way by which people hope to simplify a complicated world – a trick they hope will take the work and risk out of investing, and a ploy by which they can try to appear to be superior to the "crowd."

As I said at the outset, if the Theory is right, its widespread acceptance must mean that the Theory itself has passed its peak – and perhaps, mercifully, we will be spared from hearing so much about it in the future.[2]

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[2] This isn't meant to be an exhaustive study of the Theory of Contrary Opinion. So I haven't discussed the many times the odd-lot short-sellers turned out to be right, or the way the public selling its silver heirlooms in 1979-1980 proved to be smarter than the silver analysts, or many other ways in which the Theory has failed to live up to its promises.

WHAT WE CAN LEARN FROM THE PAST

February 9, 1984

Most technical analysts are aficionados of the past. They believe the past holds secrets that, if deciphered, would provide keys to the future. And so they sift through the past for recurring patterns that can be used as indicators for the future.

I believe their search is mostly futile. In this short article, I’ll try to show what I believe we can and can’t learn from the past.

On the Front Page of issue 72, I discussed the practice by which investment advisors look through the history of a given investment to find the moving average that has provided the best buy and sell signals. This search for the ideal moving average can serve as a starting point for my discussion of the use we can make of the past.

MOVING AVERAGES

An investment’s moving average for any given day is the average of all its prices over the recent period designed in the moving average. Thus, if you have a “50-week moving average,” today’s “M.A.” will be the investment’s average price during the past 50 weeks.

It is called a “moving” average because it changes every day – as the oldest day’s price is dropped and the current day’s price is added to the set of prices from which the average is taken.

Because this daily change has only a small effect on the resulting average, the moving average is much less volatile than the daily price. And the longer the period covered, the less the average will be affected b each day’s changing price – and, thus, the less volatile it will be.

A moving average of some length (say, 40 weeks or more) generally will remain below the price for most of a prolonged bull market, and above it during a prolonged bear market. That is, the current price, aimed in the direction of the major trend, will stay ahead of its moving average for most of a prolonged trend.

So a common strategy is to buy an investment when its current price rises above its moving average, and sell the investment as soon as its price falls below the moving average.

Sometimes, however, the price will fall below the moving average (signaling the start of a bear market) only to rise again and go to new highs. So the dedicated technical analyst will search through the past, checking every possible moving average – perhaps from 20 weeks to 80 weeks – looking for the one that has produced the most profitable signals for the investment being studied.

When he finds one, he’ll print a chart showing how well this particular moving average has produced signals telling you when to by and sell. If the signals were correct every time during the period studied, he may even refer to the average as an “infallible” indicator.

The Best of the Past

In my remarks on the Front Page of issue 72, I said the fact that one indicator had worked best for the period tested doesn’t tell a thing about the future. Every test will produce a winning indicator – even if the indicator is useless. And even within the period studied, different sub-periods usually will produce different winners.

This prompted a reader to send me a rebuttal. He said that he’d seen studies of moving-average strategies that have done a better job of identifying buy and sell points than I’ve done lately buy buying at what I thought were support levels.

He said:

I don't see why you have to have the "best" moving average to identify the trend as being up/down/sideways. You need to know only that, in the past, a strategy using a given M.A. allowed one to pick off a good part of the rise.

The key words are "in the past." The M.A. (or other) study tells you only that a particular pattern occurred in the past. You can't project from the past an assurance for the future. As someone once said, "If the past could predict the future, we'd all be billionaires."[1]

In the past, the Yankees won the World Series, Richard Nixon was elected President, the earth orbited around the sun, the dollar crashed against foreign currencies. These events *of themselves* are not guides to future events. Each one needs to be examined to see whether there's a physical or human-nature reason for it to repeat itself.

Of these events, only the earth-sun relationship can be explained in such a way that we expect it to recur regularly. The others *might* happen again, but they don't *have* to. In fact, they have no more chance to occur than an alternative chosen at random.

You might convince me that, say, the dollar will crash again. But you can do so only by offering evidence of *today's* conditions, coupled with a logical explanation of why those conditions must lead to a crash – not by saying that it will happen because it happened before.

As with the Yankees' past glories, a given moving average might happen to have done this or that in the past. But, to my knowledge, no one has even tried to explain logically why a price that falls below its moving average *must* continue falling.

1 I think it was Jimmy Carter on election night, 1980

The fact that the same moving average doesn't "win" the test for every investment, as well as the fact that other moving averages don't provide winning results, should alert you to the probability that we're dealing with a random coincidence.

PERFECT SYSTEMS

One of my investment principles is that systems such as this work perfectly in the past but poorly in the future.

There's nothing mystical about this principle. The originator of the system is showing you the "cause-and-effect relationship" that happened to win the random study he conducted; so of course it worked perfectly in the past. But if there is no natural reason for the existence of this relationship, it will work poorly in the future.

If you use a computer to generate 5,000 random one-digit numbers, one of those numbers (between 0 and 9) will occur the most often. If the winner is 6, does that tell us anything about the nature of life and numbers? Even if 6 happened to be generated far more than 10% of the time, would you attach any special significance to it? [2]

If one moving average happened to produce unerring buy and sell signals in the past, does that tell us anything about the nature of investments – the way investors behave in the markets—or provide a strategy for profiting?

The past *is* important to us, and it shouldn't be ignored. I realize that, to justify various actions, the slogan "Those who ignore history are condemned to repeat it" is invoked as often and as uselessly as "Buy

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[2] I know you wouldn't think that any number has a special significance in economics or investments. But did you know that many technical analysts believe that the number .618 is special? Any time they find it (such as when a price is .618 times its previous high), they get ecstatic and believe they've found a key support level.

when blood is flowing in the streets.” Even so, the truth is that we *do* need to consider what has happened before.

But the value of the past is in telling *us what to avoid*, not what to do.

Data Mining

Statistical analysis is used for one of two purposes – to create a theory or to test a theory. In the investment world, statistical analysis is used by technicians mostly to create theories or strategies. In the academic world, this is known as “data mining” – that is, mining through mountains of data in hopes of finding some breathtaking cause-and-effect relationship.

If an analyst finds one (such as “a 48 ½-week moving average produces infallible buy and sell signals for greasy wool futures”), he has no idea *why* this should be so – only that it *is* so (or apparently is so). And thus originates the technician’s timeworn, fail-safe, fall-back-upon justification: “I don’t know why this works, but it *always* does.”

Unfortunately, it doesn’t always work. It happened consistently during a specific period of time. And when it doesn’t happen in the future, the technician will have to choose between expanding his principle to include exceptions, going back to the computer to look for an even better indicator, or finding a way to cram the square head of current reality into the round hold of his theory.

The principle that “systems work perfectly in the past but poorly in the future” is true because you hear only about system that *would have* worked well in the past – systems that were uncovered by data mining. Because there is no basis in human action for the system that was uncovered, there is no reason for it to work in the future.

PROPER USE OF THE PAST

On the other hand, analysis of the past is very useful in testing a hypothesis that was created by deductive reasoning – applying principles of human action to specific areas of economics or investing.

If your understanding of the world tells you that Cause A should always lead to Effect B, you necessarily will want to examine past instances of Cause A to see if they did in fact always lead to Effect B.

For example, Terry Coxon and I developed a group of Permanent Portfolios (including one for the Fund) on the basis of logic – how we believed various investments should respond to various economic events. Having done so, we wanted to be sure that the real world hadn't, at some time in the past, shown our logic to be faulty.

As a test, we commissioned Data Resources to run computerized portfolio simulations from 1970 forward – to see how our portfolios would have performed during the circumstances of those years. In general, the results matched our expectations, but it did call attention to elements we'd overlooked. For one example, we discovered that the portfolios weren't as stable as we'd expected and wanted them to be, and so we increased the Treasury-bill allocations to dampen the volatility.

Suppose, on the other hand, we had programmed the computer to discover the portfolio that would have produced the best result during the period 1970-1980. Necessarily, the result would have been a one-investment portfolio (probably gold or silver). What good would that have done us – either in 1980 or today?

CONCLUSION

As Henry Hazlitt demonstrated *in The Failure of the "New Economics*", experience can disprove an economic theory, but it can't prove it. History can tell you that a given principle wasn't contradicted during a given period time, but it can't tell you that the principle will always hold up.

The world is made up of billions of people and other influences. The events of the past weren't subjected to all the influences that might affect the events of the future. If a theory didn't survive the influences that *were* brought to bear upon the events of the past, we know that the theory is wrong or incomplete. But the fact that it has survived intact so far doesn't mean that it will hold up forever.

To determine what is probably true, we have to rely on our (imperfect) sense of logic and our knowledge of the physical sciences and human action. We won't find the truth through data mining.

It's easy to say that a given moving average (or other system would have worked during some past period. But until someone can provide a logical reason that the system is valid, there's no sense in expecting it to produce profits in the future.

HOW TO HANDLE INVESTMENT RULES

April 20, 1982

Over the past month, I've read comments that could be summarized as follows:

"The end of a bear market is usually accompanied by panic selling, widespread pessimism about the investment, and plausible reasons that the price must go lower yet. Today's gold market is like that, so we must be close to the bottom. It's time to buy. Always buy when no one else wants to; buy when "blood is running in the streets."

I can't argue with that. But I couldn't have argued with it last August when gold was at $388, or in December at $400, or even in February 1981 at $500. All the crimson signs of a market bottom seemed to be present then, just as they do now.

Is the rule wrong? Is it a mistake to buy when there's "widespread pessimism" about an investment – as there seemed to be about gold last year?

This article discusses some of the problems involved in trying to use investment rules, and offers some guidelines (rules?) for dealing with them.[1]

KNOWING THE CONDITIONS

Most rules tell you to act when a given condition prevails. Buy when there's "widespread pessimism" – or buy when "blood is running in

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[1] It isn't the purpose of this article to decide whether blood is running in the streets of the gold market now; my strategy for gold is covered in the "Current Investment Suggestions." This article deals only with general principles that affect investment rules.

the streets." But such a rule presupposes complete knowledge of current conditions, and no one has that much knowledge.

How do you know whether there is "widespread" pessimism in the gold market now or just "some" pessimism? Do you ask the street cleaners if they found blood in the streets today? Unfortunately, no one can measure pessimism numerically, so you won't find it quoted in a table in *The Wall Street Journal*.

Ask a successful investor how he knew to buy or sell at a profitable time, and he may recite an age-old rule as the answer. Ask him how he knew that the time was right to apply the rule, and he may say that the conditions were right.

Ask him how he knew the conditions were right, and he'll probably say that his experience guided him. Lastly, ask him what specifically in his experience guided him, and I doubt that he'll be able to answer.

Why not? There must have been some particular match-up between the past and the present by which he interpreted the situation.

There probably was, but it isn't surprising that he can't identify it. He reacted intuitively to the situation – as we all do to familiar situations.

EXPERIENCE & INTUITION

Each of us relies on a fund of knowledge accumulated from experience. But the knowledge is so vast and complicated that, most of the time, you use it without noticing that you're drawing on it.

This knowledge is employed in the form of *intuition* – which is the unconscious processing of data from your own experience.

There's nothing mystical about intuition. It isn't a strange gift that enables a psychic to divine the future or read minds. Intuition is simply the use of knowledge acquired from experience – without conscious attention to its use.

For example, you drive a car by intuition; you don't say "Now I'll tilt the wheel slightly to the left... now I'll tilt it slight to the right." Nor do you explain to yourself why you're doing these things.

You act automatically because your mind is processing your image of the road and the other cars without your having to focus consciously on every decision and act. In fact, if a passenger asked why you did a particular thing, you might find it difficult to explain; you weren't paying attention when you acted, you made the decision unconsciously.

The execution of most acts is done intuitively – eating, walking, typing, talking, most labor. You don't analyze each step, you just do it.

However, you can do these things automatically only because you've already learned how to do them. Once the knowledge is acquired, it goes into some remote corner of your mind – to be used in the future, but never noticed directly.

The Data Bank

Once, on an airliner, I went into the lavatory, closed the door, and pushed the bolt to lock it. A few moments later, the door opened and an elderly woman walked in – properly shocked, of course.

Afterward, the stewardess said to me, "You should have locked the door."

"I *did* lock the door," I said.
"Obviously, you didn't."
"But I *know* I did."
"Why are you so sure?"

I knew there was a reason, but I couldn't think what it was.

A few days later, on another airliner, I went into the lavatory, shut the door, pushed the bolt, *and the light went on*. I realized then that the lavatory would have been dark the previous time if I hadn't locked the door.

The light in the lavatory had assured me that I'd locked the door. I'd acquired that understanding through years of flying, but without once noticing that the lavatory light comes on only when you bolt the door. As a result, I was unable to explain my assurance to the stewardess.

For a hypothetical example, suppose you walk into a restaurant for the first time, get a bad feeling about it, and want to leave. Your companion says that you're being silly – that this place has the best reputation in town. As it turns out, the service is bad, the food is lousy, and a fistfight breaks out at the next table.

You may never know what gave you the warning that something was wrong. But probably something you saw reminded you unconsciously of a bad experience you'd had elsewhere. In the same way, you might be wary of an investment even if you can't rebut the arguments made on its behalf.

Intuition is an important part of life because one can never acquire all the data necessary to make a decision by conscious calculation alone. So an investor acts when the situation feels right to him – meaning his intuition signals that the situation corresponds to earlier situations that proved to be profitable. And he refrains from acting when the situation doesn't feel right.

If it turns out that he was correct, he may not be able to explain his decision, but that doesn't mean he didn't have good reasons for it.[2]

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[2] In modern jargon, the word instinct often is used (incorrectly) to justify an intuitive decision one can't explain. But instincts are

Experience Required

It isn't that intuition is always correct; intuition can make mistakes. But everyone's reactions are at least partly intuitive, so it's impossible for anyone to lay out a set of rules telling how he would react in each and every situation. Everyone is guided by an intuition that's built up from years of individual experience, experience that can't simply be handed over to others.

Many people believe they can succeed just by doing whatever their "gut feelings" tell them. Most of them are in big trouble. One's intuition is only as valid as the background from which it flows.

Your intuition is useful in a specific field only after experience has built up a mental data bank that your intuition can draw upon. Even then, unnoticed factors might influence your intuition incorrectly. So an intelligent person usually won't do what logic tells him is unrealistic.

Why Rules Are Incomplete

Because so many decisions are made intuitively, rules coined from successful actions inevitably will be incomplete. A legendary financier may attribute his wealth to the rule "I always sold too soon." But only his intuitive reactions to the market, molded by years of experience, told him "how soon" was "too soon." Consequently, you or I might find it very difficult to profit from his rule.

This is one reason that technical analysis works for some investors but not for others who know and apply the same rules. Applying the rules calls for subjective judgments that not everyone is equipped to make well.

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motivations that preserve a species – such as hunger, sex, etc. They have nothing to do with decision-making or with one's own background.

Computer systems for technical analysis seldom work for any length of time because the computer doesn't have enough experience. All the computer knows are past prices and the formal rules that have been programmed into it. Even the most successful trader can't write a complete program of rules, because he can't identify everything he relies on in making decisions; too much of his knowledge has been stored in his own intuitive data bank.

Because we rely so much on intuition, two investors can agree on a rule but disagree on any given application of it. To one, a pint of blood in the streets is a buy signal; the other holds back until the blood is knee-deep.

And in some cases, even if an investor has stated his quantity requirement and has seen that much blood, he may decide at the last moment that he wants to know the blood type before acting.

WHERE THE RULES COME FROM

When trying to use rules, it's valuable to understand how they come into existence.

An individual's success stems from his intelligence, aptitude, conscious knowledge, and intuition. Rules are imperfect attempts to explain this success. Most are invented in one of two ways.

The first occurs when a successful, but inarticulate, person is asked to explain his success. Despite his talent, he may be unable to describe his methods. In trying to explain, he may focus on something irrelevant, or he may coin a rule that doesn't really tell how he'd handle future situations.

Or he may fall back on textbook rules he's heard but doesn't really follow. For example, if you ask a top salesman to account for his success, he may stammer and then say, "Well, I know my product, always make an extra call every day, never take 'no' for an answer, remember everyone's name, and shine my shoes." While this lends credence to the company's sales manual, it doesn't tell you how to emulate the salesman's success.

Rules also arise from attempts by others to analyze the work of a successful person. It's said that most textbooks on music composition derive from the attempts of musicologists to analyze the work of Johann Sebastian Bach. They discovered when he would use a given harmony, when he wouldn't, etc. Their discoveries have become the basis of composition theory.

But no other composer became great by following these rules to the letter. Instead, the later "greats" broke many of the "Bachian" rules. Their innovations led to additional rules that were, in turn, broken by later successful composers.

Rules are imperfect attempts to describe that actions of successful individuals. And the rules are particularly imperfect in identifying the occasions when exceptions would be made.

It isn't that the rules are wrong, unworkable, or idealistic. It's that they can be employed profitably only if accompanied by a feel for *when* the rules apply. And that feel is developed through experience; it can't be found in a textbook.

APTITUDES

Profitable investing requires more than just the experience that creates the right intuitive responses.

Investing isn’t a science – like physics or chemistry. If it were, you could invest successfully as easily as you can turn on an electric light; you’d need only to follow the instructions of those who had created the instrument at hand.

Investing is an art – for which one must have an aptitude. Some people study music for years and never compose a piece that anyone wants to hear. Others take ten college math courses and never learn to be comfortable with elementary algebra. And many people who learn all they can about investing never show a profit.

Investors who lose continually may have no aptitude for investing. Without the aptitude, the time spent soaking up experience will be wasted.

However, unlike with music and math, almost everyone has to make decisions about investments. Too much of life involves a sense of investing – even if only deciding whether to put $300 in the bank.

Almost no one can ignore investing with impunity. So it’s necessary to find a way to make investment decisions – with or without an aptitude.

Recognizing Your Aptitude

Actually, it’s an oversimplification to say that one either has or hasn’t an aptitude for investing. Most individuals are neither investment geniuses nor investment dunces, but fall somewhere in between.

Whatever your place on the scale, it’s important to acknowledge it – to recognize how much aptitude you have. Success doesn’t come from pretending you're more qualified than you are, from just wanting to succeed, or from following rules religiously without the aptitude to employ them.

Neither should you decide that you're unsuited for investing simply because you've followed a few rules without success. It may be that what you've been trying is ill suited to your aptitude and experience.

It's important also to identify how much you enjoy investing. You may be good at it, but still prefer spending your time doing other things. You shouldn't adopt an investment strategy that requires a degree of attention you don't want to give.

For someone who either has no aptitude or has no interest, there's no simple solution – such as "Just put your money in. . ." If you wealth is important to you, you'll have to devote some time to managing and protecting it. But if you accept your situation, you can develop a plan that relies on a minimum of what you're short of – aptitude or interest or both.

Putting 100% of your wealth in a balanced Permanent Portfolio is one example of such an approach. The portfolio won't materialize on its own; you'll have to do some work, learn some things, and spend some time to set it up. But having done so, the portfolio might be the easiest and safest arrangement you could devise.

In fact, the very existence of a Permanent Portfolio (as opposed to having 100% in the Variable Portfolio) is a sign of respect for your limitations. It's a recognition that no one's aptitude or knowledge is great enough to assure that short-term investment decisions can't go wrong.

RULES

Whatever course you choose, the rules defined by others can help you.

But rules are never complete. They usually presuppose total knowledge of current conditions without providing that knowledge. The application of a rule depends upon personal experience. And because so much experience is used intuitively, we can't expect a rule to explain every application of itself.

In addition, any rule must be placed within the context of who you are, what you know, and what you're capable of doing.

And so, to close this article on rules, let me suggest a few rules:

1. Rules that are said to be the basis of someone's success should be studied for their potential value. But a rule can't transfer another person's aptitude or experience to you.

2. There have been individuals who were both great investors and great teachers (Gerald Loeb, for example). But, in general, don't assume that a financial genius can explain how his genius works. You would be confusing two different talents.

3. Any rule has hidden exceptions. Not even the most articulate genius can tell you what he'd do in every conceivable situation. He knows only that, when the time comes, he'll know what to do.

4. Contrary to one rule, an exception does not "prove the rule." An exception *calls attention* to a rule. When you see a Japanese tourist without a camera, you're aware intuitively that something is strange. After thinking about it, you realize what was strange – and you coin the rule that Japanese tourists usually have cameras hanging from their necks. Be alert to exceptions; they can help to identify and refine your own rules.

5. A rule isn't a command. You don't *have* to buy when blood is running in the streets. In fact, one rule may conflict with another one – Buy when. . ." and "Never buy when. . .". You have to decide for yourself when to apply a rule – using your own experience and values.

6. While a rule isn't a command, it may be a reassurance. The "pessimism" rule that began this article can't tell you when to buy gold. But if other considerations indicated that gold is a good investment now, the rule would remind you not to be deterred by what seemed to be widespread pessimism about gold's prospects.

7. Don't try to use a rule that's contrary to what you believe to be the nature of life and human action. Someone may say that he profits from such a rule, but his success may stem from something else entirely.

8. A rule that appears to be wrong may have a kernel of truth. Examine it, measure it by what you know about life, and modify it to suit your own way of thinking.

9. If an investment rule or system seems to make sense, try for a while to employ it on paper – making definite decisions and writing them down, but not investing any money. You still may decide that the rule is sensible, but that its execution isn't obvious. However, the more you work with it, the more you'll develop a feel for how to apply it.

10. Be wary of an investment strategy that's over your head. Don't risk any large sums trying to do something until you know that you possess the necessary aptitude – and that you can give it the attention it demands. Again, try it on paper first; see whether it's something you can handle.

11. Be wary also of advice that says, "In today's world, everyone must be a [speculator, short-seller, international expert,

whatever].” Not everyone *can* be, and some people are sure to lose what they have if they try.

12. Even if you have an aptitude for investing, and even if you have good rules to work with, you’ll have to serve an apprenticeship before a great deal of success can come your way. You need to acquire the experience that will generate the right intuitive reactions to market conditions.

13. Intuition is valuable and should be respected. But a “gut feeling” that things will work out is no substitute for a stop-loss order. The more experience you have, the more valid your feelings are; but everyone’s intuition leads him astray sometimes. In any conflict between feelings and logic, let logic prevail.

14. Don’t despair if you try a strategy and can’t succeed with it. Just because you can’t be a doctor doesn’t mean you can’t make a living; just because Sophia Loren doesn’t know you’re alive doesn’t mean you can’t be loved. And just because one investment strategy is over your head doesn’t mean there isn’t another that would suit you well.

MR. JONES' INCREDIBLE FORECASTER

February 13, 1985

On Monday, Mr. Jones received a strange letter in the mail.

There was no sender's name or return address on the envelope or the letter – just a sheet of paper with a single sentence typed on it:

> The stock market will go up on Tuesday.

Intrigued by this strange note, Mr. Jones made it a point to check the stock market closing on Tuesday – and was surprised to find that, indeed, the market had gone up.

On Thursday, he received a similar note, saying only:

> The stock market will go down on Friday.

He called his broker and placed an order to buy a stock index futures contract at the close of the day (Monday) – with a second instruction to sell the contract at the close on Tuesday.

Mr. Jones didn't go to work on Tuesday. He called in sick and spent the day at his broker's office, watching the market prices on a video screen. The market had a very good day – and Mr. Jones made a profit of over $500 on his little investment.

On Thursday, he received another letter:

> The stock market will go up on Friday.

He called his broker again, but this time he bought six contracts. And, sure enough, the market was up on Friday. Not nearly as much as on Tuesday, but Mr. Jones still showed a profit of $1,3000 on his six contracts.

For the week, he had a profit of over $1,800. So he didn’t go to work the following Monday or Tuesday. Instead, he waited anxiously for the next word from the anonymous stock market genius.

He had no idea how someone was able to forecast the market so well. But what difference did it make *how* it all worked? The important thing was that it *did* work.

On Tuesday, the letter came. But this one was different. It said:

You know now that I can forecast the market perfectly. If you want to know what the market will do on Friday, send $500 in cash in an envelope addressed to Mr. Smith, c/o General Delivery at the downtown post office.

Mr. Jones ran to his bank to get the cash. He sent the money as instructed. On Thursday, he received the precious advice:

> The stock market will go down on Friday.

He called his broker and arranged to sell short 10 stock index futures contracts on Friday. And, yes indeed, the market had a big drop on Friday. Mr. Jones made over $4,000 in one day.

The next letter asked for $1,000 for a forecast. He gladly paid it, received the forecast, and won another $4,500 in the market. The subsequent letter asked for $2,000; he paid it, doubled his futures contracts, and won around $6,000.

The mysterious forecaster had correctly called the direction of the market seven times in a row.

EXCITING PROSPECTS

At this point, we interrupt the story, but we'll come back to it shortly. First, we'll see some other examples of investment genius.

By reading the ratings services, I've uncovered investment advisors who have managed to show profits every year for the past seven years – in up markets and down markets. Seven years in a row is too many to be attributed to just good luck.

We also find perfect records elsewhere. There's a technical indicator that's predicted the stock market turns seven times in row. A string of successes this long could hardly be a coincidence.

And there's a moving average that's signaled bull and bear markets in gold seven times in a row. Such consistency seems too great to be an accident; we can't object to the moving average being called a "confirmed, reliable indicator."

Lastly, a college professor teaching finance boasts of a student who's picked seven winning investments in a row. It appears that an investment genius has been discovered.

In each of these cases, the long string of successes (seven in every example) seems to prove that the results didn't come from coincidence, luck, or special circumstances that are unreliable.

And the potential suggested by these discoveries is truly exciting.

GENIUS AT WORK

Perhaps we should look more closely at one of the examples. It turns out that the college student's investment success grew out of a classroom experiment.

Each student was asked to make his "investment" by flipping a coin. If the coin came up "heads", the investment was considered to be a success. A "tails" result meant that the investment failed. So the exemplary student flipped "heads" seven times in a row; he didn't actually choose any investments.

But, still, just flipping "heads" seven consecutive times is itself quite a feat. Can you imagine what the odds are against such a thing? They must be astronomical.

However, we should understand how the experiment was conducted.

There were 128 students in the class. Each of them flipped a coin to determine the outcome of his "investment". If his coin came up "heads", he won; if he flipped "tails", he lost.

The experiment was conducted in seven stages:

1. All 128 students flipped their coins. The results were: 66 "heads" and 62 "tails:. The professor told the losers to withdraw from the experiment.

2. The remaining 66 flipped again. When they did, 31 flipped "heads". The other 35 withdrew.

3. On the next test, 17 winners, 8 flipped "heads" on the next test.

5. Of these 8, 4 flipped "heads" again.

6. Of those 4, 3 flipped "heads" on the next test.

7. Of the 3 remaining, only one flipped "heads" on the final test.

So we have one student who was able to flip "heads" seven times in a row.

Taken out of context, this student's accomplishment had seemed amazing. But taken *in* context, it doesn't seem remarkable that one student out of 128 succeeded in flipping "heads' seven times in a row.[1]

In each of the seven stages, approximately half the flippers produced "heads" – just what you'd expect. If you start with enough people (around 128) and eliminate the losers each time, the odds favor an outcome in which one or more students will flip "heads" seven times in a row.

The Odds Have It

The odds against flipping "heads" on any one toss are 1 to 1 (which is the same as saying you have 1 chance in 2 of succeeding). Against flipping twice in a row, the odds are 3 to 1 (1 chance in 4).

Against flipping seven times in a row, the odds are 127 to 1 (1 chance in 128). That may seem to be big odds, but if you start with 128 people, the odds favor an outcome in which at least one person has accomplished the "impossible".

It doesn't matter what the setting is – coin-flipping or investing or anything else. The odds are the same in *any* situation with two possible outcomes of roughly equal probability.

For example, if each of 128 investment advisors has about an equal chance to show a gain or loss each year, there should be at least one who shows a gain seven years in a row. And there are far ore than 128 advisors around.

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1 Terry Coxon says that the probability that at least one student out of 128 would flip "heads" 7 times in a row is 63.4%. I'll take his word for it.

Chance in Investment Results

If investment advice seems far removed from coin-flipping, consider this.

Suppose that each of 128 investment advisors, at the beginning of each year, decided whether to go long or short on gold (or any other investment) by flipping a coin – and then stuck with that decision throughout the year.

At the end of seven years, you'll probably have one advisor who was right every year (and one who was wrong every year).

And not one of them would have had to do an hour of research or look at a single chart.

'PROVEN' INDICATORS

No wonder there are such things as the "Super Bowl Indicator" that seem to work somehow year after year. Out of thousands of possible indicators, there will be some that have won every year – no matter how obviously foolish the premise.[2]

And if a computer sifts through daily gold prices for all the years covering the last seven market turns, testing several hundred different moving averages, it's bound to find one moving average (more likely several) that confirmed – quickly and accurately – each bull trend and each bear trend.

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[2] The "Super Bowl Indicator" says that if the winner of the Super Bowl (played in January) is a team that was I the old American Football League, the stock market will show a net loss for the year. Otherwise, the market will gain for the year. Although the results depend upon the index chosen to represent the stock market, the indicator has been accurate in almost every one of the past 18 years.

Realize this when you read of a "confirmed, reliable" indicator that apparently has forecast a market correctly. Recognize that its record doesn't tell you anything about its ability to do so in the future. Realize, in fact, that there may be no logical connection between the indicator and market events.

Even if there were no reason for *any* indicator to forecast future conditions, many indicators still would seem to do so for long periods *in the past* – simply because there is an infinity of possible indicators for investment advisors to choose from. On any day, some of these indicators are sure to have amazing track records – even if the results are pure coincidence.

Explanation Needed

No matter how many times an indicator (or advisor) has been right before, that fact alone offers no evidence that it (or he) will be right when you risk your money.

What you need to know, beyond past success, is whether there's a logical connection between the indicator and the market results – a connection arising from what we know about the way people act.

How, for example, does the outcome of the Super Bowl affect the economy so as to determine the stock market's direction? The answer to that is obvious: it doesn't.

But other indicators, residing within investment markets rather than sports areas, may be equally meaningless. You have to put them to the test of logic, not just a computer printout.

MYSTICISM

If you can't come up with a logical connection, the indicator is simply a mystical phenomenon.

Mysticism is a belief in something for which there's no cause-and-effect explanation.

If a technical analyst believes that a "pennant formation" on a chart signals a big upmove to come but can't explain why (other than to say "it always has"), his faith is mystical. He may say he's being "scientific," but his technique is no more scientific than that of a witch doctor examining animal entrails for signs of the future.

(This doesn't mean that all technical analysis is mysticism. There are charting rules that have grown out of realistic ideas about the way the world works. The *mystical* tools are the trendlines, pennant formations, moving averages, and such that came with no explanations for their existence. In my opinion, probably 80% of the technical tools I've seen are mystical.)

Use of the Past

The argument "I don't know why it works but it always has" is meaningless. You can't use the past to prove an economic hypothesis.

Once logic has created a working hypothesis, you search the past to see if history has already refuted your presumed cause-and-effect relationship. If you don't find a refutation, you're encouraged to explore the relationship further. But a refutation may still occur tomorrow – so you've "proved" nothing.

Hypotheses vs. Mysticism

But you don't even have a hypothesis if you can't explain how A leads to F by following a logical trail through B, C, D, and E. Without that trail, you have nothing more than a mystical belief.

Studying mystical phenomena can be an entertaining pasttime, but it isn't the pathway to investment profits. To reduce the element of chance to a minimum, one must deal with cause-and-effect relationships that are logical and understandable.

It's understandable, for example, that bull markets in gold tend to coincide roughly with periods of the rising inflation. What makes that relationship understandable is its consistency with various things we know about the way people act: (1) that many people around the world have long-term holdings of U.S. dollars, (2) that people try to avoid losing wealth (to inflation or to anything else, (3) that gold is the obvious alternative to U.S. dollars during periods when the U.S. dollar is losing value to inflation.

But there's no reason to accept such ideas (to use some old stock market wives' tales) that July is a bullish month, or that the market's result for January (or any other period) tells you how the whole year will turn out, or that a chart gap must be filled eventually, or that the stock market will always do well in years ending in "5's – until someone can explain, in terms of how the world works, why any of this should be so. I've yet to see anyone do so.

Advisory Records

The performance records of advisors have to be evaluated with similar skepticism.

If *no* advisor had a workable strategy, there still would be some advisors who stumbled into a decent record – even a few who compiled amazing track records. After all, there are hundreds (or thousands) of advisors. The size of the crowd favors a few spectacular results – which you can be sure will be made known to you.

But, unless you know *why* an advisor had been successful, you have no reason to believe he'll continue to be successful. You have to look at his investment philosophy and decide whether it's compatible with the world as you know it.

There's no guarantee your appraisal will be completely sound. But at least you'll be comfortable with the reasoning and strategy of an advisor whose world-view is similar to yours. And if *your* philosophy has brought you good things up to now, the chances are good that you'll choose an advisor who will do right by you.

In addition, having more than one advisor makes it easier to evaluate each of them – because they, in effect, critique each other through their presentations of opposing viewpoints.

CONCLUSION

To sum up:

1. The fact that a particular indicator has "worked" several times in a row is no assurance – nor even a suggestion – that the indicator will work the next time.

2. The most common reason that a "reliable" indicator may fail to work just when you risk your money on it is that it never did really work. It was consistent with past results only in that, out of millions of potential indicators, chance allowed it to look good – for a while – in the same way that chance allowed a particular student out of 128 to be a champion coin-flipper.

3. When someone offers you an indicator, ask whether its track record comes equipped with a logical explanation. By itself, a graph purporting to show a strict relationship between the indictor and a given result is nothing more than an interesting picture. A graph of the lucky coin-flipper's results would be equally as impressive.

4. If a plausible explanation shows why, in the world that you know, the indicator should lead to the promised result, you have something to consider using.

5. But even a plausible explanation doesn’t mean that the indicator will always work. Any economic relationship contains many variables. Sometimes there are changes in the variables that we aren’t paying attention to. As a result, the plausible indicator may point up and the result may be down. (The indicator may still be useful – even if it’s now complicated by including more variables.) We’re always working with tentative theories about economics and investing – never a final natural law that will hold up forever.

6. Realize that investment advisors love to discover special indicators. Often, an indicator is unveiled or recalled merely to support a view of the market to which the advisor is already committed. In other cases, an indicator is employed to make economics and investing seem simpler than they really are.

This doesn’t mean that all indicators are worthless, only that you have to look at more than past results. If the results preceded the indicator’s discovery, it may be that no one has actually profited from the indicator.

Nor am I saying that all advisors are worthless, only that past records don’t guarantee what’s to come.

Realize that there’s an element of chance in the outcome of every investment made. So an advisor’s record will result partly from luck – which may be good luck or bad luck. He may be better or worse than his record indicates.

One of the things you want to evaluate in an advisor is how he deals with the factor of luck and how he attempts to minimize its influence. But whatever he does, luck will contribute to the record he offers – and there’s an even chance that his luck will be different tomorrow.

Investing isn’t simple. Don’t believe that someone can reduce it to a simple indicator or a black-and-white track record. In investing, as in anything else in life, you have to search for investments, indicators, and advisors that make sense to you.

That's far more important than touted track records or the apparent success of people who are making investments you're not comfortable with.

CODA

I almost forgot. What about Mr. Jones?

The next letter he received asked for $3,000. He paid it and received a forecast saying that the market would go up. But the market went down. He lost $4,000 on his futures contracts.

Even after this loss, Mr. Jones was still $5,800 ahead. He was ready, even anxious, to pay for another forecast. After all, his mysterious forecaster had been right 7 times out of 8. But Mr. Jones never received another letter.

On the day the forecast went awry, a Mr. Smith entered into his computer the information that the market had gone down that day.

In accordance with its program, the computer went through Mr. Smith's mailing list and eliminated half the names.

The mailing list was very small now. It had started with 65,546 names a couple of months ago, but now there were only 92 names left. Pretty soon, the scheme would be over.

For the first mailing, the computer had addressed envelopes to 65,536 names. The envelopes were stuffed with notes – half saying "The stock market will go up on Tuesday" and half saying "The stock market will go down on Tuesday."

When the market had risen, the computer had eliminated the names of the people who had received the "down" letter. This routine had been repeated three more times – with the computer eliminating half the remaining list after each mailing.

By then, the list had been reduced to 4,096 names. To them, the computer addressed envelopes which were stuffed with the "Send $500" letter. Surprisingly, 1,481 people responded by sending Mr. Smith $500 each.

Of course, only half those people (740) then received correct forecasts. To those, he followed up with the "Send $1,000" letter. And 739 did so. (For the rest of his life, he wondered about the 740th person.)

Of these, 370 received the correct forecast, staying on the mailing list. After a "Send $2,000" letter and forecast, the list was down to 185 names. Mr. Jones was dropped from the list when his $3,000 forecast happened to be on the wrong side of the market.

But, even then, there still were 92 winners.

By the time the list had dwindled to 23 winners, Mr. Smith had amassed over $3 million. He thanked his lucky stars that there'd been no days when the market had finished unchanged.

He decided to end the scheme. But he'd become so fascinated with the investment markets that he decided to publish and investment newsletter.
He contacted the 23 people who'd received 10 consecutive winning forecasts. Each of them was more than willing to write an endorsement letter praising Mr. Smith's "incredible" track record."[4]

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[4] The story of Mr. Jones and Mr. Smith was adapted from an episode of "The Alfred Hitchcock Show" that Terry Coxon remembers seeing years ago. The coin-flipping example was suggested by an anecdote in *Business Week*. February 4, 1985, page 60. The examples of 7-year

INVESTING BY SUPERSTITION

March 29, 1987

Suppose you could take a walk with a top-performing investment advisor – giving you the opportunity to learn how a great mind works.

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successes early in the article were hypothetical proxies for the multitude of such claims that you and I read continually.

As you walk together down the street, he looks up at the sky and says, "The clouds are in a straight line across the horizon – a bullish sign for the stock market."

A little farther along, you come to a ladder propped against a wall. He steers you around it, explaining, "I don't want to walk under a ladder; the week ahead is going to be critical for the stock market."

You chuckle politely at his little joke. But when he glares at you, you realize he's serious. "The next week may be the crossroads," he says sternly, "determining whether stocks continue up or slip into a bear market. I don't want to take any chances."

You say to him, "You don't really believe that the pattern of the clouds or your path around a ladder has anything to do with the market's performance, do you?"

"Yes I do."

"How can you? What do clouds have to do with stocks? How does walking under a ladder influence the investment markets?"

"I don't know *how* these things work. But I can tell you this: I've been in the investment business for 14 years, and I know that they *do*."

There's no way to answer such an assertion. You can't investigate all the advisor's encounters with ladders and cloud formations over the last 14 years. But you don't feel a need to. You simply assume that any connections he's seen must be coincidence – since there's no conceivable tie between clouds and stocks, or between ladders and markets.

So, rather than argue with him, you resolve to spend the next week looking for a new advisor.

The Numbers Game

To find a replacement for the cloud-watcher, you take a friend’s advice to visit a trader who’s know to have an excellent track record.

When you meet the trader, you’re encouraged by his studious manner. Here’s a man who uses his intellect.

During the conversation, you ask him about the outlook for gold. He says, “Gold looks good. The next uptrend should last 13 months and bring an increase of $144.”

You’re impressed by his precision; he must be one of those market geniuses you’ve heard about. Here’s a chance to find out how he does it. So you ask him why he’s so sure about gold’s future.

He says, “In the last uptrend, gold gained $89, and 1.618 times $89 is $144. The number 1.618 is the Golden Ration, you know. As to the timing, the last two uptrends lasted 5 and 8 months respectively. Whenever 8 follows 5, 13 usually comes next – so the $144 rally should take about 13 months.”

You wonder whether the cloud-watcher would be willing to handle your account again.

Numerology at Work

While this story is fanciful, its elements are more commonplace than you might think.

I haven’t actually encountered much cloudophilia or ladderphobia, but the investment world is full of superstitions.

One of the more popular superstitions is numerology – the belief that certain numbers or patterns of numbers have special significance. For example, an advisor who has been quoted frequently by newspaper wire services began a newsletter article in 1986 with:

> **We forecast a new all-time high for gold in this cycle, much higher than the 1980 high of $850.**

If you’re interested in gold, that opening would certainly get your attention, and you’d want to know how he arrived at his opinion. Fortunately, he explains his reasons:

> **In the early 1970s, gold rose from $35 to $180 (the orthodox Elliott Wave high). This was a factor of 5 (35 x 5 = 175), a Fibonacci number. From 1976 to 1980, gold advanced from $103 to $850, a Fibonacci factor of 8 (103 x 8 = 824). The price low of the 1980-1985 bear market in gold was $285. The next number in the Fibonacci sequence is 13. If the current bull market in gold continue its Fibonacci relationship, then it could peak to 3705 (285 x 13).**

I’ll explain Fibonacci numbers shortly, but for now please understand that the example isn’t hypothetical or even exceptional. The superstitions I’ll discuss in this article touch perhaps 75% or more of all investment advisors. As a result, many investment strategies are founded on superstitions.

IDEAS

There are four types of ideas that you might act upon:

1. *The Verifiable*: You may not understand all the ins and outs of the law of gravity, but you can verify its central thesis at any time just by dropping something and watching it fall to the ground.

2. *The Reasonable*: You haven't actually tested the idea that you'll drown if you stay too long under water. But it is consistent with what you know about water, life, and breathing – and you can't imagine a way for the idea not to be true.

3. *The Authoritative*: You've never checked personally to be sure that Africa is located where the atlas says it is, but you trust Rand-McNally's version of the world – because you believe they've verified the matter using standards you would consider reasonable, and because you've never found them saying anything you know to be wrong.

4. *The Superstitious*: A superstition is a belief that hasn't been verified (and perhaps *can't* be verified) – for which no one has a reasonable explanation, for which you can't even imagine what a reasonable explanation might be, and for which no authoritative source has claimed that there *is* a reasonable explanation.

You don't accept the idea that breaking a mirror brings seven years' bad luck, because nothing you know about life suggests any connection between mirrors and misfortune. In addition, there's no body of authoritative opinion that accepts this idea, and it's doubtful that you'll spend seven years trying to verify it.

Superstition in Investing

Since you and I aren't superstitious, no one could convince us to worry over a broken mirror, or to act on the premise that "things happen in threes," or to pay attention to ladders or black cats.

But somehow we can be fooled into accepting more sophisticated superstitions by someone who leads us to believe that a particular investment rule *has* been verified, or explains it in a way that *seems* reasonable, or cloaks it in a mantel of authority.

As I discussed in "Why Science Can't Predict Investment Prices" in the last issue, economics and investing depend very little on principles that are verifiable – ideas that can be proven once and for all.

Most of the economic principles you act on are accepted because they seem reasonable to you or because you believe they've been checked out or thought through by someone you consider to be reasonable.

Because economics deals with the decisions and actions of human beings, an idea is reasonable only if it's consistent with what we know about the way human beings act. What electrons or planets do isn't relevant. Economic event A can be expected to lead to economic event B only if you can imagine how the actions of human beings create a continuous thread leading from A to B.

Selling Superstition

Because the principles of economics and investing can't be proven once and for all, there's a lot of room for pseudoscience and superstition. People who reject ideas about full moons and black cats readily accept superstitions pertaining to investments.

There are three principal ways that investors are induced to accept superstitions that have no reasonable explanations.

The first is with evidence that is incomplete. You're shown that event B followed event A four times in a row, but you aren't shown the seven time event A *wasn't* followed by event B. Or you aren't shown the nine times that event B occurred without event A preceding it. Or it isn't pointed out that events A and B are just two of a large group of events that seem to follow whenever event Q occurs.

The second is that the idea comes from a source you consider to be authoritative. You may respect the person who's promoting the idea because he is known to have an outstanding record, or because he once made a remarkable forecast that came to pass, or because his economic or political philosophy seems to be similar to yours. Or you may simply be bowled over by his credentials – as an economist, a scientist, or a famous person – or even by his confident manner.

The third possibility is that the idea comes wrapped in an authoritative package. It's claimed that the idea has been tested extensively and verified beyond question. Or perhaps the promoter of the idea dazzles you with mathematical and statistical techniques that are useful in the physical sciences but have no place in economics.

In other areas of life, one or more of these components might not be enough to overcome anyone's natural reserve and skepticism. But ideas that promise to make investing easy or simple generally are welcomed because most investors want so much to believe that they're true.

Investing isn't easy work. It draws on judgment, not science. There is no skill, no technique that can be relied upon to work unfailingly – no rules that provide consistent knowledge of the way a market is going to move.

In order to find something they can count on, many investors are willing to set aside their skepticism, to give any idea the benefit of every doubt, to ignore the exceptions or logical flaws that would scream at them if the subject were something other than investing.

And so superstitions are born effortlessly and repeated endlessly, and they have come to form a large part of the "common knowledge" of the investing world.

Superstition Widespread

The practice of "technical analysis" is littered with superstition. For one example, some technicians believe that an investment price plotted on a graph that forms a pattern similar to a drooping flag is a prelude to a rally – even though there's no reasonable explanation for this belief and no rigorous attempt (that I know of) has ever been made to test the idea.

Superstition isn't confined to technicians, however. In fact, it pervades the investment world. Investors and advisors rely on trading systems, on supposedly fixed economic relationships, and on legends about how investment prices move – all without demanding an explanation of why they should be true, and usually without any serious attempt to determine whether his story has refuted them.

The common explanation is, "I don't know *why* it works this way, but it always does."

But that's not much of an explanation. Even a witch doctor who forecasts the future by throwing chicken bones on the ground could argue, "I don't know why it works, but it always has." Every cult of magic, no matter how outlandish, has adherents who swear that it always works.

In most cases, the technique actually works only infrequently. However, when a person joins a cult, although he may not learn to see the future, he usually learns how to explain away the lapses between theory and practice.

Even if you see that an idea *has* worked on one or more occasions, the lack of a reasonable explanation makes the idea unreliable. Someone watching a child flipping a coin that comes up heads several times in a row might believe there was a natural law involved and say, "I don't know why it works, but it does work."

Any cause-and-effect relationship must be explained in terms of what we know about how human beings act. You should remain unconvinced until someone explains how the actions of one person lead to the actions of another, to another and another, until you arrive at the effect that's supposed to flow from the original cause.

Without such an explanation, the odds are very great that the evidence for the relationship is contrived or is the result of coincidence.

Realism vs. Superstition

Studying coincidences can be entertaining, but it isn't the highway to investment profits – any more than studying rabbits' feet is the key to avoiding accidents.

It's more productive to examine common rules of investing to see whether they're consistent with what you know about the way human beings act.

It's a common belief, for example, that gold is an inflation hedge. The idea that bull markets in gold tend to coincide roughly with periods of rising inflation *is* understandable because it's consistent with what we know about the way people act: (1) that many people around the world hold U.S. dollars as a store of wealth; (2) that people try to avoid losing wealth (to inflation or to anything else); (3) that gold – because it's liquid, portable, divisible, readily identifiable, private, and stable in supply – is a ready alternative to U.S. dollars as a store of value; and (4) that during periods when the U.S. dollar is losing value to inflation, gold's usefulness as a store of value increases.

Even if someone should refute the relationship eventually, it wouldn't mean that it had been unreasonable to accept it.

On the other hand, it is mere superstition to believe, as many people do, that gold prices *foretell* the future of inflation; or that the scope of the next bull market in gold can be foreseen by measuring the last bull market; or that gold stocks are a leading indicator of gold bullion.

No one can explain why people in the gold market should behave in such a way as to make these things happen, no conceivable explanations seem possible, and none of these ideas could stand the test of history. They are just superstitions that happen to be widely accepted.

Nor is there any reason to accept stock market superstitions such as "July is a bullish month" or "A chart gap must be filled eventually" or "The market always does well in years ending in 5" – until someone can explain, in terms of how the world works, why any of this should be so. I haven't seen anyone even try.

FIBONACCI NUMBERS

A few superstitions have the loyalty of occult-minded investors but are too bizarre for the average investor or advisor to swallow.

And yet once you stop demanding reasonable explanations for investment rules, you become fair game for just about anything anyone might dream up.

You could, for example, find yourself entranced by Fibonacci numbers – and you'd have plenty of company. Many investors and advisors believe that mathematics can unlock the secrets of the financial universe – and that Fibonacci numbers are the key.[4]

Leonardo Fibonacci (1170-1230) was an Italian mathematician who devised a numerical sequence that begins with 1 and 1, which are the "seeds" of the sequence. These are added together to make 2, which is the third number. Then 1 and 2 are added to make 3; 2 and 3 to make 5; 3 and 5 to make 8; and so on. Thus the sequence runs: 1, 1, 2, 3, 5, 8, 13, 21, 34, 55, 89, 144, and on and on – with each number after the seeds equal to the sum of the two numbers immediately preceding it.

[4] I discussed Fibonacci numbers in the newsletter a couple of times last year. Please forgive me for repeating some of that here, as the example is too appropriate not to include it in this article.

Modern witch doctors believe that Fibonacci numbers have a special status in nature and in the financial world – and they expect these numbers to show up at strategic places in an investment's future. In the example on page 104-11, the advisor saw (or thought he saw) 5 and 8, and concluded that 13 must be coming next – two Fibonacci numbers pointing to a third.

Fibonacci buffs offer no cause-and-effect explanation (that I've seen) for the significance of Fibonacci numbers. Instead they "verify" its significance by collecting examples of Fibonacci numbers in the investment world – such as an uptrend lasting 8 months. Of course, it would be amazing if there *weren't* plenty of examples – since half the numbers between 1 and 10 are Fibonacci numbers.

Adherents also are awed by the fact that the result of dividing any Fibonacci number (after the first few) by its predecessor is approximately 1.618 (55 divided by 34 = 1.618, 144 divided 89 = 1.618, and so on). If there were nothing special about Fibonacci numbers, why is there a consistent relationship between every pair of numbers?

The number 1.618 is called the Golden Ratio or the Golden Mean. This number and its reciprocal .618 have special significance in the Fibonacci scheme of things. An uptrend might be expected to stop at 1.618 times its starting price, or a downtrend might be expected to halt at .618 times the price at which it began.

Some writers have composed rhapsodies about the frequency with which the Golden Mean shows up in life. A rectangle whose length is 1.618 times its width is said to be the proportion most pleasing to the eye, and so that shape is found in paintings, playing cards, windows, doors, publications (but not *this* publication), and many other things.[5]

[5] However, if you walk around your home with a tape measure, you might not find a single example of the Golden Ratio. Of course, your house may have been poorly designed.

Fibomania

Fibonacci fans say that mathematics can be used to project the past and present into the future – if only you know the right multiplier or have the correct sequence of numbers.

And it’s true that there is something fascinating about the symmetry of the Fibonacci series and the tidy way in which each number is about 1.618 times the size of its predecessor. Once it’s been called to your attention, it’s easy to start seeing Fibonacci numbers under every bed. Somehow the world seems full of numbers like 3, 5, 8, 1.618, and 618.

Life itself seems to testify to the significance of Fibonacci numbers. And what could be more authoritative than mathematics?

But hold off before you enter limit orders to sell all your investments at 1.618 times their recent lows. What we’ve seen of Fibonacci numbers so far is true, but incomplete. The attributes of the Fibonacci series are remarkable, but far from unique. Mathematics is full of curious consistencies.

Bean Math

For example, let me tell you about the famous Italian mathematician Gabrielo Garbanzo (? - ?).

His series runs: 0, 1, 2, 3, 6, 11, 20, 37, 68, 125, 230, 423, 778, 1431, and so on. It’s similar to the Fibonacci series, but each number after 2 is the sum of the preceding *three* numbers in the series (6= 1+2+3, 11 = 2+3+6, 20=3+6+11, and so forth).

After the series gets going, divide any number by its predecessor and – lo and behold – the answer is 1.839. We can call this constant the Golden Bean. I’m sure that, once we start looking, we’ll find plenty of

Garbanzo numbers and Garbanzo Beans in the investment markets – such as an investment trend that lasted 1, 2, 3, 6, or 11 months, and ended somewhere near 1.8 times the price at which it started.

In fact, any series will produce *many* golden ratios. In the Garbanzo series, after 125, each number is 3.4 times the number that's two steps before it, and so on indefinitely.

The Proof of the Pasta

Another mathematical genius, Enrico Fettucini (? - ?), created a series made up of the *squares* of numbers: 1 (1x1), 4 (2x2), 9 (3x3), 16 (you get the idea), 25, 36, 49, 64, 81, 100, and so on. This is the famous Fettucini Series.

Some years later, his son, Alfredo, used the differences between each pair of adjoining numbers in the series to create a second series: 3 (4 minus 1), 5 (9-4), 7 (16-9), 9 (got it?), 11, 13, 15, 17, 19, and so on.

What do you know? Each number is 2 greater than its predecessor. This is the famous Fettucini Alfredo Series.

Fun with Numbers

Mathematics is full of surprising consistencies, symmetries, and other curiosities. There are entertaining books full of oddities and games played with numbers. And there are numbers that seem to show up wherever you look.

The number 2 is the basis of almost all music phraseology in western civilization. Musical phrases, fragments, songs, and sections fit into standard lengths of 2 bars, 4, 8, 16, 32, or 64 bars – all powers of 2. When a phrase is any other length – 3 bar or 5 bars, for example – it sounds lopsided.

Literature is brimming with the number 3. You never read a story about someone posing 4 riddles or 7 riddles; it's always 3. The hero never has to face 2 tests or 5 tests; it's always 3. The trinity appears throughout literature – not just in Christian theology.

Because we use the decimal system, the number 10 appears especially significant. We think of the numbers 10, 20, 800, 3000, for example, as being round – while 64 or 89, although not jagged, just aren't round. And numbers ending in 5 are usually considered round because they add up so easily in decimal arithmetic. But in octal arithmetic (a counting system that uses a base of 8 rather than a base of 10), 64 is as round as 100 is in decimal arithmetic.

Almost any number has its own claim to significance. There's 1 (unity), 2 (as in music), 3 (as in literature), 4 (seasons), 5 (round number), 6 (Satan's number), 8 (music again), 9 (3 squared), and 10 (there's nothing rounder). The only number between 1 and 10 without special significance seems to be 7 – and you know what *it* means.

Fibonacci numbers have no special claim to being nature's darlings – and certainly are of no importance in the investment markets.

USE OF SUPERSTITION

If I've labored the matter of Fibonacci numbers too long, please forgive me – but there's an important point here. You can't identify the likely highs or lows of an investment trend by playing with numbers.

In addition, the Fibonacci enthusiasm points up how easily an investor with a limited knowledge of mathematics can be dazzled by numerical fireworks that seem to be proving something.

You might assume that bizarre subjects like Fibonacci numbers are of no particular importance, and that only the less-than-serious investor would give them the time of day. But that isn't the case. Many advisors set their watches by Fibonacci numbers.

Many of the investment forecasts you've ready may have been constructed using Fibonacci numbers – even though the forecasters didn't bother to tell you that. And Fibonacciphilia is only one superstition that guides investment advisors.

I know many advisors personally, and I know many more through reading their works. While I haven't made a methodical study of the popularity of superstitions, I estimate that:

♦ About 2% of investment advisors use astrology in their work;

♦ At least 15% of all advisors pay attention to Fibonacci numbers, with the figure closer to 50% among people in the futures and commodity markets;

♦ At least 35% believe that history repeats itself as if reading from a script – and so they study such things as 21-day cycles, 5-month cycles, 4-year cycles, the 54 Kondratieff Wave cycle, or Elliott Waves;

♦ Perhaps 75% adhere to one or more rules of technical analysis that have neither reasonable explanations nor verified records of predictive powers.

These practitioners aren't found only on the fringes of the advisory business. Some of the best-known advisors take Fibonacci numbers seriously. And many well-known advisors act on rules of technical analysis that have no more foundation than the famous natural law, "Things always happen in threes."

Math

The fascination with Fibonacci numbers is part of something more wide-ranging and more dangerous – the widespread belief that economic questions can be answered by playing with numbers.

Most investment advisors believe that a great deal can be discovered by multiplying, adding, or dividing something with something else – even though there are no principles in economics that can be applied by mathematical calculation.

Attaching significance to certain numbers because they happen to be in the Fibonacci series may seem ridiculous to you. But the next time you draw a trendline on a chart, ask yourself why you’re doing it. A trendline is nothing more than an attempt to use two significant numbers to create a series of other significant numbers.

Mathematics doesn’t have the mysterious powers hoped for by investors and advisors who read buy and sell signals in the moving averages of an investment price; or who measure the lengths and heights of previous bull markets to foresee the scope of the next bull market; or who try to discover next year’s inflation rate by projecting the patterns of past inflationary periods.

Because mathematics is so important in the physical sciences, its significance for economics may seem self-evident. As a result, very few investment advisors even question whether mathematics is an appropriate tool in the many cases in which they use it.

The only legitimate meeting of economics and mathematical calculation is in the area of statistics.

We use arithmetic to add up quantities of wheat or total the money supply, to calculate gains and losses in investments, to compute yields from prices, to determine indices of market prices, to compute rates of growth. These uses are purely descriptive; the answers they give will be the same no matter what human beings may decide to do in the future.

But it's a misuse of mathematics to apply it to questions that will be answered in the future by the actions of human beings. No mathematical formula can tell you how much consumers or investors will value something in the future – or even in the present.

Rules that purport to use mathematics in this way have no credentials; they are pure superstition.

SUPERSTITION

Investment markets aren't moved by ratios, divisors, numerical series, cubes, or lines drawn on graphs – nor are they moved by chicken bones. They're moved by human beings buying and selling in accordance with their own private hopes, concerns, beliefs, and aspirations – values that change constantly and allow no measurement.
There is no way to verify absolutely the worth of any trading system, indicator, or investment rule. And, no matter how commonly accepted, no such system or rule should be considered to be authoritative.

So it's imperative that you apply the test of reason to any method of trading system, method of investment analysis, or rule you consider. There must be an explanation that shows how the rule evolves from the actions of human beings pursuing their own goals.

Statements like "It works," "History repeats itself," "The markets are moved by fear and greed," or "Human nature never changes" aren't explanations. They are merely slogans.

Even the ideas that do make sense aren't necessarily unyielding laws of nature. Plausible ideas, like the best-laid plans, often turn out to be incorrect or incomplete.

That's why I've insisted so much on the idea of having a Permanent Portfolio that will protect you no matter what ideas might lure you into taking risks with the Variable Portfolio.[6]

[6] I would provide a more personalized strategy but, of course, I can't do that without knowing your sign.

10 QUESTIONS YOU SHOULDN'T ASK ABOUT INVESTMENTS

February 17, 1995

Very often, investors buy the wrong investments for their needs because they ask the wrong questions.

Here are 10 popular questions investors ask — each of which clouds the issue, rather than clarifies it — together with questions that will solicit the information you really need to know.

RISK

2. <u>"Is there any risk?"</u>

Of course there is risk. No investment is risk-free. Risk is simply the possibility that the investment won't do as well as expected.
What you want to know is:

- In what economic circumstances is the investment's price likely to go down?
- Are other investments in your portfolio likely to take up the slack by gaining in those circumstances?
- What is the most you can lose on the investment? (Usually every penny you put it into it.)

SAFETY

3. <u>"Is this investment safe?"</u>

What does <u>safe</u> mean?

That the price can't go down? Bank accounts don't fall in price so long as the bank stays in business. But they can lose real value during inflationary periods.

No investment is perfectly safe. There isn't a single one that can't lose value in some scenario.

What you want to know is:

- Under what circumstances would I lose a substantial share — 20% or more — of my investment?
- Under what circumstances would my entire investment be lost?
- Do I have any residual liability — that is, can I lose more than my cash investment?

INCOME & CAPITAL APPRECIATION

4. "What is the investment's yield?"

Interest and dividends (an investment's yield) are two of the three ways you can gain from an investment. The third way is through price appreciation.

All three give you money you can spend. But the first two ways are immediately taxable, while the third might not be taxable for many years.

Looking for the highest yield leads to two kinds of trouble.

First, interest rates generally reflect an investment's risk. A higher interest rate means there's a greater possibility the capital can be lost — through default or inflation. And a high dividend yield often means an investment isn't likely to appreciate in price — and may even mean the company is paying some of its capital in dividends.

Second, chasing yields can cause you to overlook other factors — and may even cause you to consume capital, rather than preserve it. Suppose, for example, that in 1970 you had put your capital into long-term Treasury bonds yielding 6%, with the thought that you would live on the income and preserve the capital. Consumer prices doubled during the 1970s, cutting the purchasing power of the bond interest — and your standard of living — in half.

In addition, inflation caused current interest rates to rise, so that bond prices steadily depreciated. Your capital was slipping away from you. Even if you held the bond to maturity, you got back dollars of much smaller value than those you had invested.

You may have thought you were "living off the income, not the capital," but by 1980 your capital had been cut by 20% in dollar value and 60% in actual purchasing power. And the income was buying only half the living standard expected of it.

Yield, by itself, is only a half-truth about the investment. What you also need to know is:

- Under what circumstances, if any, is the investment likely to appreciate?
- Under what circumstances, if any, is the investment likely to depreciate?
- In good circumstances for the investment, will the overall return — yield plus capital appreciation — help your portfolio?

If the investment is a mutual fund, you want the fund with the lowest yield — other things being equal. Any dividend paid by a mutual fund simply reduces the price of the fund by a comparable amount — so that the dividend is coming out of your own pocket. And even though you gain nothing from the dividend, it adds to the current year's taxable income — causing you to pay taxes on a phantom profit.

TRACK RECORD

5. "How well did this investment perform in recent years?"

You may get tired of hearing it, but we do have to remind ourselves that past performance is no guide to future success. Investments have their ups and downs. And if you buy an investment after a few up years, you may be jumping in just before it's ready for a few down years.

This is true as well of mutual funds, market timers, and other advisors.

What you need to know is:

- What kind of economic climate should cause this investment to prosper?
- When that climate has existed, <u>did</u> the investment prosper?
- If this investment is for a balanced portfolio, will buying it give you too many investments dependent on that one kind of climate — making you too vulnerable to some other economic climate?
- If this is a speculation, do you think we're heading into the economic climate that favors this item?

SPONSORS

6. <u>"Who thinks this investment is about to rise?"</u>

No one — not even the most astute investment advisor you can think of — knows how the investment will do next year.

Every advisor has about an even chance of being right when forecasting whether a particular investment is headed upward or downward.

It doesn't matter how good his record has been for picking stocks, timing the market, or spotting next year's winners. Never forget my first rule of investment advice:

> The advisor with the perfect record will lose his touch when you start acting on his advice.

It does little good to know who is recommending an investment. The important questions are:

- Why is he recommending the investment? Do his arguments make sense?
- What does he believe it will add to your portfolio?
- What will have to happen for his forecast to come true?
- Do you want to bet on that event with funds you can afford to lose?

TAKING THE PLUNGE

7. "How much should I invest?"

No one can tell you how much to invest in an item because no one is in your circumstances.

If this investment is to contribute to a balanced portfolio, ask yourself:

- How much of the investment do I need to provide the proper balance against other investments in the portfolio?
- How big an investment would make me too vulnerable to some potential event?

If the item is being considered as a speculation, ask yourself:

- Since the entire investment could be lost, how much can you afford that investment to be?

"SOCIALLY RESPONSIBLE" INVESTING

8. If a company or a mutual fund, "Is it socially responsible?"

The stock exchange isn't a pulpit. If you want to promote a particular environmental policy, political philosophy, or personal enthusiasm, do it with the profits you make from hard-headed investing.

Maximizing profits and conforming to social policies are separate endeavors. You can cater to one endeavor only at the expense of the other. So it makes sense to focus on sound investing, and then — if you want — use the profits to indulge your political beliefs.

The management's policy is important in some cases. For example, if you buy a mutual fund to add to a Permanent Portfolio's balance, you're counting on the fund to perform in a certain way in various economic climates. You want to know that the investment will be just as appropriate next year as it is today. So ask:

- Is the management's policy a consistent one that you can count on — engraved in the prospectus?

TAKEOVER CANDIDATE

9. "Is this company a potential takeover candidate?" (or does it have some other fashionable characteristic?)

There is no information you can obtain about a company that isn't available to everyone else in the marketplace. Thus whatever is attractive about the company probably is already reflected in its price. If the company does what is expected, the price might go up a bit — as what is probable is transformed into fact. But if the expected event fails to materialize, the price may drop a long way — as the unexpected catches everyone by surprise. So when you act on the expectation of a takeover (or some other hope), you are risking a lot to gain a little — exactly opposite to what a speculation should be.
So don't ask or hope for significant information. Ask yourself instead:

- Do you interpret the widely known information in a different way from what most people believe?

Large speculative profits are earned only when you go against the crowd. The crowd isn't always wrong, but you can't make much betting with it — because you will buy at a price that's already high.

By going against the crowd, you buy when an investment is out of favor and cheap; if it does succeed, there's a long way for it to go up.

So the most important factor in speculating is whether you expect something that most people don't expect. The time to consider buying inflation hedges speculatively is when most people believe inflation is under control. The time to consider buying a particular company is when everyone knows what a dog it is — not when everyone talks about its great promise.

Unpopularity isn't a guarantee of profits, but it's a prerequisite.

POPULARITY

10. "If this investment is so good, why don't I see it recommended in newsletters or Money magazine?"

As discussed in the last answer, unpopularity is a essential to a speculation. So you can't expect to make big profits without feeling a little lonely.

If the investment is being considered for your Permanent Portfolio, you have to decide whether it adds to the portfolio's safety — while the recommendations you see in newsletters and magazines almost never will consider what your portfolio needs.

If someone discusses the investment you're considering, ask:

- Is the advisor helping you decide whether the investment is right for you, or is he simply guessing whether the investment will go up in price?

If the latter, ignore the advice. If the former, and his information seems sound, take it into account when making your decision.

TECHNICAL ANALYSIS

11. "Do the technical factors favor the investment now?"

That question really is a proxy for about 2,487 questions: Are the moving averages rising? Is investor sentiment bullish? Is that a head-and-shoulders formation I spy on the chart? Is its tail between its legs? And so on.

No matter how many times a given indicator has signaled correctly in the past, it has only an even chance of being right this time — just as you have an even chance to flip a coin heads, no matter how many heads or tails have come up already.

Instead, ask yourself:

- Is there something on TV that's more interesting than these charts?

SUMMARY

Always define carefully what you are trying to achieve. You must have an investment plan.

Without a plan, you will be tossed and turned by all the conflicting ideas you read and hear — and you'll never ask the right questions.

With a plan, you'll have a basis for evaluating whatever you hear. You'll know to ask the questions that help you determine whether the investment furthers your plan.

THE 16 GOLDEN RULES OF FINANCIAL SAFETY

July 23, 1997

Over and over we read of a famous person who made a great sum of money as an entertainer, sports star, or business genius — only to lose it all.

Sometimes the individual lost his money because of poor investment decisions or because he became involved in a business for which he had no aptitude or experience. Other times it's because a money manager had too much control of the money and too little monitoring. Or a would-be tax expert set up a complicated tax-shelter scheme that didn't work and brought on heavy penalties.

Every time I read one of these stories, I'm struck by the tragedy. Someone has lost everything and is unlikely to recover it because his big-income days are past.

And I'm struck by how senseless the tragedy is. The individual had so little to gain from the unnecessary risks he took, and so little chance to succeed with them.

Pay No Attention to the Rich & Famous

When you read that one of the richest people in the world — someone like Bunker Hunt or Donald Trump — has declared bankruptcy or is in financial trouble, it's easy to feel a sense of futility about managing your own money. If such a person — able to afford the best financial advice in the world — can't hang onto his money, what chance do you have?

But the wealthy individual didn't fail because he received a bad forecast about the future, lacked access to the right kind of information, or picked a poor investment. His undoing was in violating some basic rule of financial safety. Had he followed the simple, common-sense rules of investing, his wealth would still be his.

And the rules by which he is bound, and which he violated, are the same principles that apply to your finances. If you abide by those rules, there's less than one chance in a million that you could lose all you have.

I call these common-sense principles the 16 Golden Rules of Financial Safety.

1. **Your career provides your wealth.** You most likely will make far more money from your business or profession than from your investments. So don't take risks with complicated investment schemes in the hope of multiplying your capital quickly. You're risking a lot to gain a little.

2. **Don't assume you can replace your wealth.** The fact that you earned what you have doesn't mean you could do it again. Markets change, laws change. And, as time passes, increasing regulation makes it harder and harder to earn a fortune. So treat what you have as though you could never earn it again.

3. **Don't use leverage.** When people go broke, it's almost always because they were operating with borrowed money — even though they may already have been quite rich. If you handle all your business and investment affairs on a cash basis, there's practically no chance you could lose everything – no matter what might happen in the world.

4. **No one can predict the future.** Events in the investment markets result from the decisions of millions of different people. And those events never unfold as expected. Investor advisors have no more ability to predict the future actions of human beings than psychics and fortune-tellers do.

5. **No one can move you into and out of investments consistently with precise and profitable timing.** You'll hear about many Wall

Street wizards, but the investment advisor with the perfect record up to now most likely will lose his touch the moment you start acting on his advice.

6. **No trading system will work as well in the future as it did in the past.** You'll come across trading systems or indicators that seem over and over to have signaled correctly where an investor's money should have been, but you can assume the systems will stop working when your money is on the line.

7. **Recognize the difference between investing and speculating.** When you invest, you accept the return the markets are paying investors in general. When you speculate, you attempt to beat that return — to do better than other investors are doing — through astute timing, forecasting, or stock selection, and with the implied belief that you're smarter than a mere investor. There's nothing wrong with speculating — provided you do it with money you can afford to lose. But the money that's precious to you shouldn't be risked on a bet that you can outperform other investors.

8. **Don’t let anyone make your decisions.** You don’t need a money manager and, above all, never give anyone signature authority over money that’s precious to you. You have no way of knowing what he may be prompted to do someday by pressures or problems.

9. **Don’t ever do anything you don’t understand.** It doesn’t matter that your favorite investment advisor, your best friend, or your brother-in-law understands something. It isn’t his money at risk. It’s better to leave your money in Treasury bills than to take the chance that someday you’ll discover there were risks or liabilities you couldn’t see at the outset.

10. **Keep some assets outside the country in which you live.** Don’t allow everything you own to be within the reach of your government. You’ll be less vulnerable, and you’ll feel less vulnerable — and you won’t have to worry so much about what the government will do next.

11. **Beware of tax-avoidance schemes.** Tax rates are still low enough in the U.S. that you might gain very little from the risk and effort of constructing elaborate tax shelters. Complicated tax schemes

may include many vulnerabilities and liabilities of which you're not aware.

12. **Don't depend on any one investment, institution, or person for your safety.** Every investment has its bad periods: the inflation of the 1970s hurt stocks, bonds, and even Treasury bills — while the 1980s were terrible for gold. Real estate lost its luster when the tax rules changed in 1986. And as we've seen, you can't count on institutions either — as banks, savings & loans, and pension funds have gone under.

13. **Create a balanced portfolio for protection.** For the money you need to take care of you for the rest of your life, set up a simple, balanced, diversified portfolio (what I call a Permanent Portfolio). Design the portfolio to assure that your wealth will survive any event, including events that would be devastating to one or more of the portfolio's investments. This needn't be complicated; you can achieve a great deal of diversification with a surprisingly simple portfolio.

14. **Speculate only with money you can afford to lose.** If you believe it's possible to beat the market, set up a separate pool of money (what I call a Variable Portfolio) with which you can speculate to your heart's content. But make sure this pool contains no more money than you can afford to lose.

15. **Enjoy yourself with a budget for pleasure.** To enjoy your wealth, allow a budgeted amount that you can spend each year without concern for the consequences. If you stay within the budgeted amount, you can blow this money on cars, trips, anything you want — knowing that you aren't blowing your future.

16. **Whenever you're in doubt about a course of action, it is always better to err on the side of safety.** If you pass up an opportunity to increase your fortune, there always will be another chance. But if you lose your life savings, you might not get a chance to replace them.

UNDERSTANDING INVESTMENT SUCCESS

January 14, 1987

Last year, I published articles on the two principal schools of investment analysis – fundamental analysis and technical analysis. The articles concluded that each school has as many flaws as virtues.

In addition, I’ve said over and over that consistent success at forecasting is impossible; that the track record of an investment advisor should be taken with a grain of salt; that economic science has no formulas by which to calculate the future; and that a great deal of investment advice is based upon superstition.

Actually, that’s the *good* news – because it helps to explain why so few things in the investment world work out the way they’re expected to.

And there’s even more good news. There *are* successful investors and speculators. And there are advisors who provide valuable services to their clients – services that help the clients make and keep profits.

I believe it’s possible for you to succeed as an investor – or else I wouldn’t write this newsletter. But I think it’s important to understand what kind of success is possible and what kind may be out of reach.

A great deal of investment capital has been lost by investors who misunderstand the success they see others achieving. So this article will examine the elements that make a speculator successful – to show why simply imitating him won’t work.

We’ll begin by looking at the wide range of talents and personalities among investment advisors.

THE GAMUT OF ADVISORS

There's no lack of variety in the advisors who populate the investment business.

Many advisors and writers are reasonable and helpful; a few are even wise. Others are chronically wrong in their information, in their logic, and in the recommendations they make.

There are noisy advisors who have little to offer but flamboyance and showmanship – although you'd never know that from hearing them describe themselves.

Some advisors are just plain dangerous. Their ideas, systems, and strategies could cost you dearly because they give no thought to the risks attached to their recommendations. They are relay stations for rumor and misinformation. They stir your anxiety about real or imagined threats to the world. Their explanations are sloppy, and their suggestions sometimes are deliberately ambiguous.

There also are advisors whose hearts are in the right place but whose judgments usually land elsewhere. They seem to have a knack for being in the wrong place at the wrong time. Fortunately, some of them have other virtues; they may be good educators or helpful in supplying information.

Most advisors are neither saints nor great sinners. Some have particular strengths – as educators, informants, tacticians, entertainers, even tranquilizers. And each has his own weaknesses.

The Winners

Our concern here is with advisors who, from time to time, show flashes of genius. They sometimes have thoughts about the market that are truly perceptive, original, and profitable.

They aren't always right. But sometimes they're spectacularly right – calling attention to possibilities that others have overlooked.

Generally, these advisors don't concern themselves with strategy or detail. Their primary concern is where the markets are headed. And in that regard they seem to have more hot streaks than other advisors.

But in a number of puzzling cases, if you look closely at these people, it's hard to believe they could be successful at anything. Let me tell you about four of them.

Mr. Mystic

The first advisor seems to be two different personalities.

One side of him preaches and practices a kind of mysticism that explains the workings of the world by reference to one of the superstitious cycle-wave theories that make the rounds. In this persona, the advisor's comments and explanations are worthless.

But sometimes he sets aside his charts and magic spectacles, and speaks in English. When he does, he offers valuable and perceptive insights into the markets – and even into the non-investment world. At such times his ideas are worth hearing.

The record of his specific investment recommendations, while not outstanding, is above average – good enough that I'm willing to believe he has a feel for the way markets move.

Mr. Unappreciated

The second advisor might be described charitably as a manic-depressive, paranoid schizophrenic. He is bitter, lonely, crying out for attention and recognition – the kind of person you'd like to have living next door.

And yet sometimes he comes up with spectacular forecasts that are both unusual and successful. He often sees things that others miss. And occasionally he has a hot streak in investment recommendations that runs for a year or more.

Of course, he’s made the normal share of wrong guesses – which means quite a few. And some of those wrong guess have been costly for his customers. You could never be safe relying blindly on his recommendations. But if you can look beyond his self-pity, you often find good ideas lurking among his sniffles.

Mr. Occult

A third advisor loves to dabble in the occult. In his newsletter, he often plays with Fibonacci numbers and other mysticisms.

But when it comes time to make a decision – to buy or sell - he forgoes the pleasure of witchcraft and relies mainly on his sense of the market. That sense has been remarkably right sometimes, and rarely very far wrong.

Mr. Other-World

The fourth advisor is so disconnected from the real world that he actually invited his newsletter subscribers to send him their personal experiences with changing retail prices – which he intended to use as data for a consumer price index he believed would be more accurate than the one compiled by the government.[1]

Despite this kind of thinking, he managed to produce the best performance record for 1985 of the advisors monitored by *The Hulbert Financial Digest*.

Strange Winners

[1] Maybe his circulation is larger than the government’s.

For his faults, none of these advisors sounds very promising. But somehow each of them has earned a place in the upper ranks of the advisory business.

How could this be?

How could people with such silly ideas or troubled personalities do so well? Is there no justice in the world?

One possibility is luck, of course. But I’ve watched three of these advisors over a number of years. And each of them is pretty consistently right – or at least perceptive – in certain areas, while often wrong in others. Luck wouldn’t be so discriminating.

And in the areas in which they’re generally right, their statements usually are reasonable. This leads me to believe that each one has a special aptitude in a certain area.

Unfortunately, the advisors aren’t satisfied to accept their abilities for what they are and concentrate on them. Instead, they roam into areas where their talents aren’t as great, or they attribute their success to ideas an intelligent person can’t accept.

To understand the nature of their success, and to consider the possibility that you might be as successful, we need to examine the roles of talent and intuition – which are elements of success in any field.

TALENT

In every area of life, we recognize the importance of talent.

We know there are musicians, athletes, comics, writers, artists, architects, actors, and orators whose abilities go far beyond what they’ve learned from schooling or experience.

And this is true not only in glamorous occupations; we see the special brilliance that some people have as cooks, flower arrangers, woodworkers, mechanics, hairdressers. You undoubtedly know people who have unusually good memories, or who are “good with their hands,” or who have unusual abilities to draw pictures or add large numbers in their heads.

In all these cases, the special ingredient that sets the person apart is a *talent* for a particular task – a talent he “comes by naturally.”

Mindful of the importance of talent, you wouldn’t expect to become a celebrated pianist just by reading a book by Liberace. In fact, you know that even ten years of study with Liberace might not turn you into a professional pianist – or even a very good amateur. The crucial question is whether you have a talent for music in general and for the piano in particular.

Talent is a factor in any job, craft, art, or hobby.

You probably could learn to type 50 words a minute, but – no matter how smart you are or how long you practice – you might never match the talented typist who turns out 100 words a minute.

Whatever talent you have for something, training can make it more effective. But it won’t increase your talent or give you more potential than your talent will allow.

No one doubts this when the subject is music or athletics. When the subject is investing, the point is less obvious – but no less true.

Talent for Investing

Talent is just as important in the investment world.

There are people who were born to be speculators, and speculators who wish they'd never been born.

Many writers or advisors tempt you with the idea that you could become a great speculator, another Bernard Baruch, a millionaire many times over – if you'd just follow the rules practiced by the great.

It's a wonderful idea. But, unfortunately, it doesn't make sense.

Would you expect to make it to the stage of the Metropolitan Opera just by reading a book called *Luciano's Favorite Singing Tricks*? Would you expect to become an inventive genius like Thomas Edison just by watching an old Mickey Rooney movie?

Why should it be plausible, or even possible, that you (as well as millions of other investors) could become a stock-market whiz by learning the tricks of a recognized genius?

As I'll discuss later in the article, many elements of investing can be learned and put to use profitably without any special talent. But beyond these techniques is an art that can't be taught or captured in a list of rules.

An art requires a talent that no effort or education can produce. Some people study painting for years but never paint anything you'd want to look at. Others fill their school days with math courses but are never really at home with algebra. And many people learn all they can about investing but always seem to buy the wrong things.

Apart from those who have simply been lucky, the people who achieve spectacular investment success do so because they have a talent for investing. Some of these winners are unrealistic, unattractive, even unintelligent people – but they have a *talent for sensing the movements of markets.*

Talent isn't everything. Because of other factors, some talented people are more successful than others. And the *lack* of a natural talent for investing doesn't leave you helpless.

But any plans you may have to become a star investor or speculator are empty if they disregard the part that natural talent plays.

INTUITION

Not only is it impossible to copy the tricks of someone whose talents are different from yours, it's difficult even to identify what those tricks are.

Very few geniuses can explain their gifts. This is because so little of what they do operates solely on explicit, step-by-step reasoning.

This, of course, is true for most of what *anyone* does. For example, when you drive a car, you don't say to yourself, "Now I'll turn the wheel slightly to the left . . . now I'll turn it slightly to the right . . . now I should shift gears." Nor do you explain to yourself why you're doing these things.

You act automatically because your mind is taking in and processing information about the road, the traffic, and the speed and direction of your car – all without your having to make conscious decisions. In fact, if a passenger asked why you did a particular thing, you might find it difficult to explain. You might not even have noticed doing it.

You weren't paying attention when you acted, you made the decision unconsciously, and so it's very difficult to identify the reasons for what you did.

When you make decisions without noticing the step-by-step process, you're using *intuition* – which is the unconscious processing of information and ideas.

There's nothing mystical about intuition. It isn't a strange gift for divining the future or reading minds. It's simply a facility, that everyone has, to make a judgment – right or wrong – without paying attention to *how* the judgment is made. When intuition operates, you analyze information and ideas without noticing the process until the answer comes to the surface of your mind.

With intuition, you size up a stranger as honest or dishonest, or judge whether a house is one you'd be happy living in – without being able to identify all the factors that influenced your decision.

Most everyday activity runs on intuition – eating, walking, writing, talking, most physical labor and a great deal of mental labor. You don't ponder each step, you decide and move before you realize what you've done.[2]

Intuition in Investing

A speculator acts intuitively, too.

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[2] Habit also is involved in many activities. But habit and intuition aren't the same thing. Intuition is a part of your intellect – a way by which you form judgments and opinions about what is true or what to do in a particular situation. Habit, on the other hand, is a facility that allows you to do repetitive things easily. In tuition is a part of what you are, but habit is wholly learned (and can be unlearned).

He buys when he senses that he should, perhaps because his intuition notices a critical similarity between current market conditions and earlier situations (not explicitly remembered) that proved to be profitable. Or he may stay out of a market because, unconsciously, he detects a hazard that others haven't noticed – one that makes him uneasy.

If you ask him how he made his decision, he probably won't say, "It just felt right to me" – even though that may be the most accurate answer. More likely, he'll cite a half-dozen economic factors or technical indicators to explain his judgment.

But it's unlikely that those were the deciding factors. For one thing, there were similar indicators that pointed in the opposite direction. The things he cites may be important – but his final decision was intuitive, and thus doesn't allow a complete explanation.

However, the fact that he can't explain why he acted as he did doesn't mean he didn't have good reason for what he did.

Experience

Investment talent operates intuitively for the most part. And it draws on experience – which provides a fund of information for intuition to process.

Financial experience isn't the only kind that serves you. In making investment decisions, you draw upon what you know about human nature; on what life has taught you about making decisions; on what you've found to be logical or silly, careful or careless; on your ability to evaluate people's opinions and arguments; on your memories of how fads and fashions have changed; and on thousands of facts of life.

Experience of any kind contributes to your ability to make good intuitive decisions.

Intuition & "Gut Feelings"

Intuition has gotten a bad name – in part because so many people try to dignify mere guesses, hopes, and wishes by citing the authority of their "instincts" or "gut feelings."

But you can't convert a bad investment decision into a good one, or succeed with a sloppy strategy, by saying that your "gut feelings" are telling you to do something.

Intuition is valuable, and should always be respected. But it's no better than your talent, intelligence, and experience. And it doesn't have the power to overrule reality; in any conflict between feelings and logic, let logic prevail.

My purpose in discussing intuition isn't to encourage you to disregard logic and reality. My purpose is only to explain why it is that some people succeed without being able to give satisfactory reasons for their success.

RULES

Some writers and advisors promise to turn you into a successful speculator by teaching you the rules for beating the markets – rules formulated from the words of great achievers.

Doers & Teachers

But great achievers are rarely good teachers. They aren’t necessarily even good thinkers. So you’re asking a financial genius to have a second great talent when you expect him to explain how his genius works.

This is true in any line of work. For example, ask a successful salesman how he does so well. He can’t really explain his craft, but he won’t want to seem stupid or unsociable.

For want of a better answer, he’ll probably repeat what he’s read in the company manual or in books on selling. He’ll tell you he makes extra calls every day, remembers everyone’s name, never takes “no” for an answer, controls the interview – all the platitudes of selling.

But his answer doesn’t explain anything, because most other salesmen do these things, too, as best they can. He doesn’t know *what* to say because he doesn’t know *why* he’s a superior salesman.

He can’t explain how he senses which prospects are more likely to buy or which approach a given prospect will respond to, or how he knows when to ask for the order. Part of his talent is that such decisions are obvious to him. You might as well ask a bird how it flies as to ask the salesman how to be sensitive to people’s wants.

Few people would think to ask a great athlete how he runs so fast. We know that good training improves his running ability, but we also know that his speed is primarily a natural talent. So we don’t ask him to concoct a recipe that will enable anyone to run a four-minute mile.

In the same way, but less obviously, some people are born mechanics, born designers, or born speculators. Such a person reacts intuitively to each situation as it develops; don’t expect him to reduce his talent to a list of explicit rules.

Honest Answers

Some achievers believe they do know why they succeed, but their opinions aren't always correct.

Intuition can't be observed, even by the person using it. So it's very easy for someone to attribute his success to the wrong thing, to a rule that isn't really used, or even to an elaborate analytical system that's unworkable. I've often seen an advisor or speculator credit a successful investment or career to reasons that simply made no sense.

It would be a lot more helpful if the great achiever explained his latest coup by saying, "I acted as I did because it *felt* like the right thing to do." Hearing such an answer, one would be less likely to try to imitate his methods.

However, as with the salesman who recited platitudes, few achievers are comfortable conceding that they don't fully understand their own success.

Exceptions to Rules

Rules are attempts to describe the methods of successful individuals. But even the most perceptive and articulate genius can't tell you what he would do in every conceivable situation.

Every formal rule has many exceptions, since its author can't imagine every circumstance that might arise. When he runs into an exceptional situation, he'll adapt accordingly. But people who are trying to act on his rule have no way of knowing that a circumstance is exceptional until they trip over it.

In addition, a situation may appear to be governed by more than one rule. Accommodating contradictory rules may be easy for the intuitive genius, but his followers might not know how to deal with the dilemma.

This is one reason that technical analysis works for some investors but not for others who know and apply the same written rules. There are judgments involved that everyone will make in his own way – using his own talent.

Computer systems for technical analysis seldom work for any length of time because a computer's only talent is for calculation. And the computer calculates only within the limits of the rules that have been programmed into it.

Not even the most successful trader can write a complete program of rules for the computer to follow, because he can't completely pin down the rules by which he acts. Nor can he imagine in advance every circumstance that might arise. Consequently a computer program eventually runs into situations that its creator would handle differently.

Application

Formal rules are never complete answers. Even if a rule is correct, its application depends upon personal experience and present circumstances.

Because people rely so much on intuition, two investors can agree on a rule but disagree on its use. They might both say that you should "buy when blood is running in the streets" (buy an investment when all the news about it is bad), but one of them might think a pint of blood is a buy signal, while the other waits until he thinks the blood is knee-deep.

And even when one of them sees sufficient blood, something about the situation may tell him to wait until he determines the blood type.

But rules do have a value. "Buy when blood is running in the streets" doesn't really tell you when to buy an investment. But if other considerations indicate that now is a good time to buy, the rule can remind you not to be deterred by widespread pessimism about the investment.

THE ROLE OF INVESTMENT ANALYSIS

Allowing for talent and intuition makes it easier to understand why a theory of investment analysis can work for one person but not for another.

For example, many academic studies have set out to test various rules of technical analysis. Most of them conclude that there's nothing about it that "works." And yet I'm convinced that some investors and advisors use technical analysis profitably; I believe I do so myself.

How can something fail a systematic test but still be useful in practice?

I think it's because a technician who's successful uses technical analysis in ways different from what he says – even in ways he doesn't realize. He succeeds by intuitively following rules he may not have identified.

So the rules he recites probably will fail rigorous testing because they aren't the rules by which he succeeds. They don't describe everything he takes into consideration – or might take into consideration.

I would be more fitting to test the technician than to test the rules he claims to follow.

Inspiration

But even that isn't the whole story. I doubt that any successful technician makes his decisions solely on the basis of what his charts show him.

I think he uses technical analysis not so much for the specific answers it gives, but as a routine for keeping in touch with the market – and as a tool of inspiration. The charts and indicators and other paraphernalia of technical analysis may be no more than exercise equipment for his mind.

The same is true for *any* type of investment analysis. The competent analyst studies the data to get his mind in motion, and to get a feel for what the market is doing.

He'll never find objective, scientific evidence to convince him absolutely that an investment or a market will go up. If there were such evidence, thousands of other investors would also see it – and would be bidding up the price.

The *un*talented analyst will use his research in accordance with rigid rules – believing he's responding to clear, unequivocal buy and sell signals. But the talented analyst knows that such signals don't exist. He studies the indicators to gain a sense of the market; and nothing he finds is taken as a command to act.

Viewing the same ambiguous indicators that the ordinary analyst views, the talented analyst intuitively makes better judgments.

And, because opportunities come in *shades* of promise, part of the judgment he makes is whether to pass up buying opportunities that qualify by the "rules" but just don't seem right to him.

In many cases, an analyst may be using his research only to see whether it contradicts what his intuition is telling him – or simply to keep himself busy while his intuition does the real work.

When all the analysis is finished, a speculator enters a market because *it feels right to him* – no matter what his favorite tools and indicators tell him.

Mechanical Application

Those who make wrong judgments about the market fairly consistently do so, I think, because they're trying to apply an economic theory or system of analysis they believe in, but lack the talent to handle.

Investing and speculating aren't mechanical techniques, like jazzercise. If it were, making money would be as simple as loading a videocassette, turning on the TV, and jumping up and down. Speculating requires judgment, adaptation, and imagination.

In the late 1970s, two advisors I know, using elements of fundamental analysis, decided at about the same time that you could capitalize on the boom-bust business cycles by switching between common stocks and gold. The cycles had been produced with some regularity by the Federal Reserve's policy of stop-and-go expansion of the money supply.

But by the early 1980s, the Fed had changed its approach, other things had changed as well, and the character of the cycle was altered significantly. One of the advisors abandoned the strategy almost immediately, while the other continues unsuccessfully to try to make it work – even in 1987.

Those without the touch for speculating get no help from any school of investment analysis – no matter how much they study it – because they're mechanically following rules that aren't sufficient, by themselves, to bring success.

MAKING USE OF A GENIUS

Some advisors seem to have the touch, and some don't. But no one is right all the time, nor is anyone always wrong.

Some people do have a talent for imagining realistic possibilities for the future that others overlook. But the fact remains that no one can predict the future reliably or in any profitable detail.

And so even the best speculator will be wrong a good part of the time. For this reason, however great his talent may be, he won't succeed without a strategy that allows for losses.

Unfortunately, many advisors who have a good feel for the market have no sense of strategy. Following their suggestions consistently could lead eventually to bankruptcy.

So you can't succeed by simply doing whatever the genius is doing. Nor should you automatically bet against the chronic loser; now and then he'll miscalculate and do something right.

However, it's worth knowing what these people are up to. When you're about to take a speculative position in the market, you'll want to reexamine your plans if you find that an advisor you respect is taking an opposite position – or if you find that you're marching arm-in-arm with the perennial loser.

LEARNING

You can’t learn to be a market genius, but you can learn a great deal to make yourself a good investor and perhaps a better speculator than you are now.

Investing & Speculating

First, we should recognize that investing and speculating aren’t the same thing. Investing is an attempt to earn a return by making your capital available to an investment market. An investor is willing to accept the same return (in yield and capital appreciation) that the market delivers to *anyone* who invests his capital there.

Speculation, on the other hand, is an attempt to earn a profit by outguessing the market – by beating the market. The speculator hopes to earn a better return than he could achieve by simply making his capital available.

Buying a group of stocks or mutual funds that represent the overall market is investing. Choosing a few stocks or a mutual fund that you believe will outperform the market is speculating.

Holding some gold as a permanent hedge against bad times is investing. Buying gold because you believe inflation will come back this year is speculating.

Arranging and keeping a Permanent Portfolio to protect yourself against anything is investing. Trying to protect yourself by moving from one investment to another as you perceive the economy moving is speculating.

Learning to Invest

There are many things about investing that can and should be learned: the mechanics and practices of various markets (in bonds, options, currencies, and so on), as well as principles for developing a good strategy, for hedging against things you fear, for creating balance and safety, for assessing risk, and more.

Learning to Speculate

There also are many things you can learn about speculating: how to control risk, how to handle losses, how to let your profits run, and so on.

Learning these things won't increase your natural talent – but they can improve your results, because a realistic strategy is necessary even if you're good at picking winners.

If you have a talent for speculating, you might learn from almost anything that has to do with speculation – including what other speculators have to say. Financial books and periodicals can stimulate your thinking – even if what you read is wrong, misguided, or unrealistic. You aren't reading to be told what to do; you're reading for inspiration – to prod your mind to clarify your own ideas about how markets move.

If you have no talent for speculation, that material won't do you much good. And it might confuse or mislead you.

You can't learn how to spot a winner – not through education and not through experience. No one can teach you a feel for markets. But if you do have a talent, there's a great deal you can do to refine it and to make it more effective.

Your Opportunities

Although I've spoken of genius in this article, talent isn't an all-or-nothing thing. It comes in all degrees – from a little to a lot. Most people have at least *some* talent.

You don't have to be a genius to have enough talent to enjoy speculating or even to make money at it. So you may want to try your hand at speculating to see how you do.

If you're just beginning, go slowly. Start by investing on paper only – making definite decisions to buy and sell, but without actually entering the orders. Keep track of the results. If you do actually make the investments, limit them to the minimum practical size, so that you can't lose very much.

If you find that you do well, then speculate in earnest. But never get carried away. *Always limit speculations to capital you can afford to lose.*

And no matter what kind of hot streak you find yourself on, realize that hot streaks end. Don't let yourself believe that you've found a system that can't lose – or that you're so smart, you'll never lose.

Be thankful for every profit you make, and treat each new speculation with the care and humility you gave your first investment – because it has just as much chance to go wrong.

Motivation

On the other hand, you might have no desire to speculate.

Even if you're good at investing and speculating, you might prefer to spend your time on other things. If so, accept the fact. Don't adopt a program that asks you to devote more time to your investments than you can give gladly.

If you like to spend hours studying the markets, do so. Enjoy yourself – but know that you're doing it by choice, not from necessity. If you like, subscribe to dozens of newsletters and stay in touch with all the telephone hotlines.

But if that sort of thing bores you or – worse yet – if it scares you, *don't do it*. You don't have to.

No matter what anyone says, you don't have to become a sophisticate, a daredevil, or a busy bee to protect yourself.

Don't Dare to Be Great

However, even if you have no talent or interest, you can't afford to neglect the subject of investing entirely.

You have to make some financial decisions just to hold on to what you have or to earn a conservative return on your capital. So, even if you have no aptitude for investing, you have to do *something*.

But you don't have to become a speculative genius. You can develop a relatively simple plan that's tailored to your own supply of talent and motivation.

For example, you don't need to make talented investment decisions to set up a Permanent Portfolio that can protect you. You'll have to spend a few days working out the details; but from then on, you should be able to take good care of your portfolio by monitoring it only once or twice a year.

Whatever you do, recognize your own limits. A sure road to financial ruin is to resolve to do something you don't know how to do, don't have the talent for, or don't really want to do.

Your investment program will be successful only if it accepts you as you are.

Maybe You *Will* Be Great

But, as you evaluate your talents, don't judge yourself too harshly.

A few failures don't mean you're incompetent. They may mean only that you've been trying things that are over your head – or that might be unrealistic for anyone to do.

And, with time, your knowledge and skills may grow – allowing you to be comfortable with things that now seem exotic, and allowing more of your natural talent to emerge. Some of that talent may have been overruled up to now by attempt to imitate other people's talents.

The strategy that's too sophisticated today may be a breeze tomorrow. So, if you want to be a better investor or speculator, take the time to read, consider, and test ideas and strategies.

But when you *act*, always recognize the limit of your skills at the time. Don't undertake investment plans today that go beyond the abilities you have today.

SUMMARY

I hope this article has helped to clear up some of the mysteries surrounding successful investors and speculators – and the theories and rules they profess.

Talent is the key to speculative success. Talent gives some speculators the ability to imagine possibilities that others miss, to foresee potential movements in markets, to sense whether the time is right for a move.

Talent can't be learned or imitated. The actions of a talented person can't even be explained satisfactorily, because talent operates largely through intuition.

Most explanations of speculative success are misleading – even those coming from a successful speculator. He can't identify all the reasons for his decisions, because so many of his decisions are made intuitively.

Although many successful investors and advisors attribute their success to some school of investment analysis or to a system, it's more likely that those methods are merely tools to exercise the mind – not road maps to profits. A successful speculator uses investment analysis to gain a general feel for the market and to get his mind in motion – not to arrive at clear-cut, yes-or-no answers.

So don't expect to succeed by copying the methods of a successful person. Don't expect to get an accurate and satisfying answer to the question, "Why did you make this decision?"

Speculative talent can't be reduced to a set of rules. So don't expect to acquire such a talent through education.

However, education *can* show you how to be a better investor and a better speculator – to deal with risks more realistically, to satisfy investment needs more reliably, to protect what you have, and to speculate on the future without risking what's precious to you.

And, perhaps, to bring out of you the talent that *is* there.

ABOUT THE AUTHOR

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Harry Browne was an American free-market Libertarian writer and the Libertarian Party's 1996 & 2000 candidate for President of the United States. He was also a well-known investment advisor for over thirty years, author of "Harry Browne's Special Report" -- a financial newsletter published from 1974-1997, author of 14 books and thousands of articles, Co-founder and Director of Public Policy of the libertarian Downsize DC Foundation, host of two weekly network radio shows -- one a political and the other a financial show, host of an ETV (internet-based television) show called "This Week in Liberty with Harry Browne" on the Internet based Free Market News Network, a consultant to the Permanent Portfolio Family of Funds, and a popular inspirational public speaker.

APPENDIX

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