Preface

Investors should start with a view of skepticism.

—Arthur Levitt, former Chairman of the United States Securities and Exchange Commission (SEC)

When I was in high school, I had a rather colorful American history teacher. A compact man with closely cropped gray hair and a decidedly Hemingway-esque demeanor, Mr. Ryan was, in the best sense of the word, a skeptic. In our classroom discussions, he quickly established a reputation for questioning assumptions and challenging conventional wisdom. He pushed us to expose sloppy thinking—especially our own—and not be afraid of challenging views that were widely held and espoused. Though I picked up a good bit of history in that class, the most vivid lesson had nothing to do with the Founding Fathers or the Louisiana Purchase. Mr. Ryan's passionate belief was that the most important skill in life you can develop is the ability to *think critically,* though in truth he had a slightly less genteel way of phrasing the point.

Mr. Ryan's lesson has stuck with me through the years and remains one of the most important things I learned in school. Time and time again in my career I have been reminded of the merits of a healthy dose of skepticism when it comes to evaluating financial decisions. Whether in the boardroom or around the kitchen table, being willing to question assumptions and not be distracted by irrelevant or misleading information is a highly valuable skill, and sadly one that is not developed often enough in our schools. Far too often, we fall prey to having our attention focused on the inconsequential rather than the essential. Through modern media and advertising, we face a veritable blizzard of useless information vying for our attention. Keeping track of the truth through such a haze of falsehoods, minutia, pretensions, and misdirection requires considerable energy and diligence. And nowhere is the impact of critical thinking more pronounced than in the investing world, where it can make the difference between success and outright disaster.

Since most of us do not try to become self-educated authorities in every aspect of our lives, we seek advice from experts. In working with such experts, including those who fix our teeth, service our cars, and prepare our taxes, we walk the fine line between knowing enough to stay out of trouble, and wasting time and energy on things that we don't really need to learn. However, the perils of making big mistakes or being led astray by phony wisdom are particularly vivid when dealing with decisions about your money.

If you spend any time at all on the subject of personal finance, your skeptical eye will have noticed the deluge of claims that you can beat the market, generate millions of dollars in quick rewards, impress friends, and look better in a bathing suit, all by following a few simple investing rules. Most would correctly view such claims with a healthy dose of doubt, if not outright derision. Putting it mildly, there is a lot of dumb advice out there when it comes to investing. If fact, many of the most important ideas from financial economics, promoted by popular media and advertised by financial services firms, are distorted or misused in order to sell more products and services. Things that you hear about the most (such as past performance) are often among the least important factors in making good investment decisions, while aspects that are crucially important (like fees and expenses) are often hidden from view.

As with many things in life, a good strategy to use when you lack experience is imitation. Want to learn how to make better investment decisions? Look at how the most skilled and experienced professionals invest the billions of dollars in their care. Methods used by multibillion-dollar institutional investors are directly applicable to the decisions faced by individual investors (albeit with differences in the way the problems are framed). Moreover, so are the results. Today the technology exists to perform the same analyses on your investments that institutional investors used to pay hundreds of thousands of dollars to carry out—and accomplish the task in a few minutes. What does this analysis do for you? It helps you understand how different decisions affect possible future outcomes and how to structure portfolios that will improve your odds of success. So-called *outcomes-based* investing can be a revelation for those faced with difficult choices. The key to good investment decisions is making informed choices. Life is unpredictable. That might sound like a cliché tagline from an insurance commercial, but it really is true. We do not get to pick which future we will live through, but we can structure investment strategies that contemplate the full range of possible outcomes.

For the past 11 years, as a founding employee and head of investment management for Financial Engines, I have been in the unique position to both witness and participate in the migration of institutional investing techniques to the world of individual investors. Financial Engines has been a pioneer in bringing the best of financial economics and institutional money management to everyday investors through independent and personalized advisory and investment management services. The creation of these services required significant insights into how the best practices from academic and institutional finance could be applied to the needs of individual investors—insights that I will now share with you.

What you need to know to make good investment decisions can be distilled down into 10 basic concepts:

- Recognize the linkage between risk and reward
- Avoid being deceived by history
- Leverage the wisdom of the market
- Select an appropriate risk level
- Avoid the perils of stock picking
- Don't spend too much on investment fees
- Diversify intelligently
- Select funds using relevant forward-looking criteria
- Understand how to realistically fund financial goals
- Invest tax-efficiently

Each of these concepts is explored in the chapters that follow. Some of these ideas will seem like common sense, some will seem counterintuitive and surprising; all of them are important in making good investment decisions. This book builds from some basic intuition on how financial markets function, to practical tips on evaluating trade-offs, to real-world advice on selecting investments, building portfolios, and maximizing the chance of reaching your financial goals. If you learn and follow these principles, you will become a better investor as well as a better judge of whether you are getting good advice. The half-truths, shoddy thinking, and bad advice you regularly encounter in the investing world will become that much more apparent—and that much easier to avoid.

I first began mentioning to friends and family that I was considering writing a book on personal investing in the winter of 2006. The reaction was usually an enthusiastic thumbs up, but I could not help wondering if they were secretly harboring thoughts more along the lines of "Oh boy, another personal finance book . . ." By my informal count, there have been about a million books published on the topic of investing. Second only to cooking and getting men and women talking to each other, few subjects seem to enthrall prospective authors like investing. When I began my research for this book, I went out to my local bookstores and surveyed the genre. With a few notable exceptions, what I found was that most personal finance books come in one of three basic flavors. First there are the engaging *concept* books—filled with witty anecdotes about people using the concept (such as value investing, commodities trading, or real estate speculation) to get rich and achieve Zen-like peace. While this category of book can be a fun read, like a meal of stir-fry vegetables, you often find yourself hungry again after only a few hours. When you are done, there remains that disquieting feeling of "what did I really get from this?"

Next are the personal finance *potpourri* books, filled with every manner of charts, tables, statistics, and investing minutia you can imagine. These volumes take a throw-the-spaghetti-against-the-wall-and-see-what-sticks approach to financial education. The appeal here is to the hard-core do-it-yourself investors; those who find comfort in memorizing IRS contribution limits and understanding the finer points of municipal bond credit ratings. Although chock full of information, drawing actionable advice from the pages of such books is left as an exercise for the reader.

Finally there are the *academic* books, which contain interesting and valuable information, but where the use of advanced math and financial jargon put the conclusions out of reach for all but the most determined readers. Reminiscent of a formal 10-course French dinner, it takes an adventurous palette, a big appetite, and considerable endurance to get the most from the experience. Unless financial economics is your passion, chances are most of these books never make it to your nightstand.

What seemed to be missing from the personal investing genre was a book that distilled the most important intuition from modern financial economics down to a few key ideas and then combined it with practical advice on how to make better investment decisions. How do you identify the most important factors in determining investment success? How do you judge what is valuable advice and what is pure baloney? And how do you come up with a successful investment strategy when the future is uncertain?

Another profound frustration with the personal finance genre is that all too often the material stops just short of giving people the information they need to make actual decisions. Generalities are all good and fine, but *what should you actually do?* Investment advice, like finding your significant other, is a highly personal affair. Differences between individuals matter a lot. With this truism in mind, Financial Engines has agreed to waive the fees for a 12-month subscription to its award-winning *Personal Online Advisor* service for purchasers of this book, so that you can apply the ideas presented here to your own personal circumstances. Any book, with its limited length and static content, can only go so far, but an interactive investment advisory service can provide that final crucial step of connecting abstract ideas with real-world circumstances. While you don't need to use the *Personal Online Advisor* service to get value from this book, I hope that you will find it to be a helpful and enlightening resource.

My goal in writing this book was to provide you with the literary equivalent of meatloaf—a compact, but rewarding meal that sticks to your ribs (apologies to vegetarians for the choice of metaphor). I will illustrate what really counts in making personal investment decisions through simple explanation of powerful ideas and bringing them to life with real-world examples from my experience with Financial Engines clients. I'll introduce you to some of the secrets that institutional investors have known for decades, but where most individual investors are still in the dark. Consider it a crash course in financial critical thinking.

Writing a book that imparts useful knowledge in an easily digested manner is difficult. Accomplishing this goal while creating an engaging read that you would not be embarrassed to be seen reading on the beach is a daunting goal indeed. I hope that you find this book to be interesting, enlightening, provocative, and at least occasionally entertaining.

To paraphrase the famous satirist Ambrose Bierce, I trust that you will not find that the "covers of this book are too far apart."