

‘This book packs an extraordinary amount of insight into a deceptively small space’ Stephanie Flanders, *Financial Times*

‘Mr Kay is a brilliant writer.’ *Wall Street Journal*

‘It will probably be the cheapest and most valuable investment IFAs can make, both for themselves and for their clients.’
Russell Taylor, *Money Management*

‘Beautifully written and immensely readable.’ Jeremy Peat,
formerly chief economist, Royal Bank of Scotland.

‘I am in awe’ Andrew Hilton, Director, CSFI

‘John Kay is one of the most engaging and accessible writers on economics in Britain today’ *Morning Star*

JOHN KAY is ‘both a first-class economist and an excellent writer’ (*Financial Times*). He is a visiting professor at the London School of Economics, a Fellow of St John’s College, Oxford and director of several public companies. He contributes a weekly column to the *Financial Times*. He chaired the UK government review of Equity Markets which reported in 2012 recommending substantial reforms. He is the author of many books including *Obliquity* [9781846682896] and *Other People’s Money* [9781781254455] both published by Profile Books.

**the
long
and
the
short
of
it**

a guide to finance and
investment for normally
intelligent people who
aren't in the industry

Second Edition

John Kay

P

PROFILE BOOKS

This second edition published in Great Britain in 2016 by
PROFILE BOOKS LTD
3 Holford Yard
Bevin Way
London
WC1X 9HD
www.profilebooks.com

Copyright © John Kay, 2009, 2016

10 9 8 7 6 5 4 3 2 1

Typeset in Minion by MacGuru Ltd
Printed and bound in Great Britain by
CPI Group (UK) Ltd, Croydon CRO 4YY

The moral right of the author has been asserted.

All rights reserved. Without limiting the rights under copyright reserved above, no part of this publication may be reproduced, stored or introduced into a retrieval system, or transmitted, in any form or by any means (electronic, mechanical, photocopying, recording or otherwise), without the prior written permission of both the copyright owner and the publisher of this book.

A CIP catalogue record for this book is available from the British Library.

ISBN 978 1 78125 675 6
eISBN 978 1 78283 268 3



Contents

<i>Preface</i>	ix
<i>Acknowledgements</i>	xv
1: SENSE AND THE CITY	
Can you be your own investment manager?	1
From gentlemen to players	8
2: BASICS OF INVESTMENT	
Before you begin	14
Review financial risks outside your investment portfolio	18
Investment choices	20
Realistic expectations through conventional investment strategies	22
Table 1: Distribution of assets by long-horizon funds, 2015	25
Table 2: Average returns to retail investors, 1995–2015	29
Table 3: Performance of UK retail funds 2005–15	29
3: INVESTMENT OPTIONS	
Sense about shares	34
Basics of bonds	41
Pillars of property	46
Facts about funds	51

4: EFFICIENT MARKETS

Efficient markets and asset values	56
Illuminating but not true	61
Information asymmetry	65
Strategic trading, moral hazard and market manipulation	68
Investment strategies for imperfectly efficient markets	71

5: THE MIND OF THE MARKET

Market psychology	76
When the market loses its mind	83
The power of conventional thinking	87

6: IN SEARCH OF FUNDAMENTAL VALUE

Accounting for earnings	96
Table 4: CAPE (Cyclically Adjusted Price:Earnings) ratio in different equity markets (July 2015)	97
Creative accounting	99
Cash is king	106
Fundamental analysis	110
Competitive advantage	113

7: RISK AND REWARD

Risk and uncertainty	121
Subjective expected utility	125
Think probabilities	126
Comparing distributions	129
Table 5: The cumulative frequency distribution from tossing a coin	130
My ship came in	134
Diminishing marginal utility	139
Mind your portfolio	142
Table 6: Value of alternative portfolios depending on the fate of the shipbuilding nationalisation bill of 1976	142
The capital asset pricing model	146

8: A WORLD OF UNKNOWNNS

Unknown unknowns	151
Narratives and patterns	157
Mirages, systems and hot hands	159
Table 7: Percentage of funds in each performance quintile, 2004–9, with above-median performance in 2009–14	160
Table 8: Percentage of funds in each performance quintile, 2004–9, surviving to 2014	164
Models and their limits	165
Forecasts and their limits	170
Approaches to risk	175

9: MODERN DEVELOPMENTS IN FINANCIAL MARKETS

Derivatives	181
When bonds were no longer boring	188
Alternative assets	190
Structured products	198

10: THE CONVENTIONAL INVESTOR

Establish your portfolio	205
Table 9: Save now, spend later	206
Pay less	211
Table 10: Available UK retail investment funds, at end-2015	213
Table 11: Relative performance of UK retail investment funds, 2005–15	215
Table 12: Relative performance of UK retail investment funds in non-UK asset categories, 2005–15	216
Table 13: Percentage of sterling-denominated open- ended funds outperforming relevant index (at December 2015)	216
The conventional investor's portfolio	218

11: THE INTELLIGENT INVESTOR'S STRATEGY

Developing a strategy	222
Reviewing your goals	226
Diversification is the key to managing risk	230
The illusory security of cash and bonds	234
Contrary thinking	237
Market timing	241
Asset allocation	243

12: INTELLIGENT INVESTMENT

Diversify	247
Fund selection	250
Property	252
Stock picking	253
Stock selection	256

13: THE CUSTOMERS' YACHTS

<i>Glossary</i>	270
<i>Bookshelves and Bookmarks</i>	283
<i>Bibliography</i>	287

Preface

The purpose of this book is to give you the information you need to be your own investment manager. The first edition was written in 2008, as the global financial crisis was unfolding, and published in early 2009. Subsequently, I wrote and published *Other People's Money* (Profile and Public Affairs, 2015), which analyses the process of financialisation that culminated in that crisis and puts forward a programme of reform.

This comprehensively revised and updated version of *The Long and the Short of It* is a natural companion to *Other People's Money*. The critique of the finance sector developed in *Other People's Money* raises two questions: what should be done to protect the public interest, and what should I do to protect my own interests? The concluding chapters of *Other People's Money* attempt to answer the first of these questions. *The Long and the Short of It* attempts to answer the second. In one respect, my task here is easier. To reform the financial sector, we need to persuade politicians, regulators and the public. To reform your financial affairs, the only person I need to persuade is you.

In this book, I'll describe the investment options available, and the institutions that will try to sell them to you. I'll explain the principles of sound investment, and introduce you to the research that supports these principles. Sound investment is based on the returns from productive assets, and in a modern economy these are mostly owned by companies. So I'll describe how businesses succeed, and fail, in generating value for their

shareholders, and how to distinguish fact from fiction in what they tell you.

Profitable investment involves risk, and the returns from investment are uncertain. Amateurs and professionals alike are bad at managing investment risks, although for different reasons. I'll discuss why, and explain the theories that try to clarify how we assess risks and the evidence that provides partial, but only partial justification, for these theories. I'll go on to develop a practical investment strategy for the intelligent investor, based on three fundamental principles – pay less, diversify more and resist conventional thinking – and give you the specific information you need to implement that strategy.

I'll describe the sophisticated innovations of the modern financial system. The same innovations that led directly to the global financial crisis of 2008. The world I will describe is complex and sophisticated, but greedy, cynical and self-interested. The only way to cope is to acquire your own knowledge and form your own judgement. You cannot, unfortunately, trust people who offer financial advice. If you can trust me, it is because the only product I am trying to sell you – this book – is one you have already bought. Even so, I need to insert the caveat that I am not offering advice that is specific to your circumstances, that I am not recommending any particular investment or investment product to you and that I accept no liability whatever for the consequences of your investment decisions. When they work out badly – and some of them will – it will be your fault, and when they work out well – and I hope some of them will also – you will certainly take the credit. I will explain that even a decision that works out badly may have been a good decision. But that is not a proposition that ambulance-chasing lawyers, crusading journalists or politicians wise after the event find easy to accept. So I am not going to offer advice, only suggest how you should make your own decisions.

Most investment books advise you how to trade; I suggest you

trade as little as possible. Most investment books advise you to get to know the mind of the market; I suggest you think for yourself instead. Most investment books take for granted that your search for new investments is a search for stocks that are likely to go up. While I'm certainly not going to dissuade you from that, I suggest you give equal weight to a different question: is this investment different in character from those I already own?

In this book I shall describe the principles of intelligent investment that lead to these, and other, unconventional conclusions. But you will probably want to begin with a more conventional stance, and I would encourage you to do so. The conventional investor follows the average of what professional investors do. The power of conventional thinking in the City is so pervasive that this is, in reality, what the vast majority of professional investors do themselves. But you can follow that consensus with the aid of publicly available information and the properties of efficient markets. Instead of paying heavily for conventional thinking, you can use conventional thinking for free.

The conventional investor is in awe of those who have a deep understanding of what 'the market thinks'. He should be: he is typically paying enough for the privilege. The education of the conventional investor begins with forming a sceptical view of financial market expertise. The intelligent investor doesn't care what 'the market thinks', save to the extent that its mistakes and irrationalities create opportunities. For the conventional investor, risk is being out of step; for the intelligent investor, risk is losing money.

But it is uncomfortable to be out of step. And the conventional investor will do as well as the average of professional investors, which isn't bad, and better than the vast majority of retail investors. The strategy I recommend is that you begin as a conventional investor, and as you gain experience and confidence, you devote an increasing fraction of your portfolio to intelligent investment. The intelligent investor has a mind of his or her own,

can take a sceptical view of market wisdom and make his or her own risk evaluation. Such detachment enables the intelligent investor to earn better returns with less risk of loss.

The term ‘intelligent investor’ originates with Benjamin Graham, who wrote a book with that title. Graham’s modern disciple is Warren Buffett, the most successful investor in history. He has claimed that

Observing correctly that the market was frequently efficient, they (the academics – and many investment professionals and corporate managers) went on to conclude incorrectly that it was always efficient. The difference between these propositions is night and day. (Cunningham, quoting Buffett, 2002)

I’ll paraphrase Buffett’s remark by saying that markets are 80 per cent efficient, but the profits from investment are mostly to be found in the 20 per cent that is not.

There is more to this comment – a lot more – than meets the eye. Your immediate, and understandable, reaction might be to ask ‘tell me about the 20 per cent’. But I want first to raise the more general philosophical issue. What does it mean to say that a theory is 80 per cent true? We’re used to the idea that theories are either true or false. There isn’t room for theories that are partly true, or mostly true.

But we have to find room. The world of business and finance is comprehensible only with the aid of theories, such as market efficiency, which are illuminating but not true. It would be easy to pursue this issue into the philosophy of science, but this is intended to be a practical book. I shall simply make the pragmatic assertion that you cannot be an intelligent investor if you believe either that markets are always efficient or that they are not mostly efficient – if you believe that the efficient market hypothesis is true, or if you believe it is false. The same is true of two other theories – the capital asset pricing model and the approach

to risk analysis that I describe as ‘subjective expected utility’ – theories which are central to modern finance theory and to the risk control models widely used in financial institutions.

The 80/20 per cent hypothesis – that the world of business and finance is best understood with the aid of models that are partly true, partly false, is at the heart of this book. You need to understand both the 80 per cent and the 20 per cent. It is necessary both to be familiar with the ideas of efficient markets and subjective expected utility, and yet not to take either notion too seriously. Intelligent laypeople, who approach finance and investment without preconceptions, may find this easier to accept than professionals who have been forced to take one side or another in a debate.

The target readers of this book have to deal with issues of finance and investment because they have been successful in some other, unrelated, activity. These readers expect the same level of intellectual seriousness as from a book of popular science or popular history, and that is the level at which this book is written.

Many issues of finance and investment are, necessarily, technical, and their explanation involves jargon. I’ve provided at the end of the book a glossary which offers quick definitions of many terms that may be unfamiliar. The jargon is the language of the financial professional. No apology for jargon should be required if the explanation of its meaning needs to be a good deal longer than the word or phrase itself. There is one conspicuous exception to that principle – the use of the term ‘high-net-worth’ for ‘rich’. I hope there is none of the jargon of the management world, in which new terms are coined to conceal emptiness of thought.

But this book is not an academic monograph. I have kept references to a minimum. I give references to enable the reader to check the sources of claims made. In a final section on book-marks and bookshelves I have indicated some books and web

sites that readers can use to pursue issues further. I have not thought it necessary to provide links to the commercial web sites of product providers – these are very easy to locate – but I have included details of some useful web sites that provide information or comparisons useful to intelligent investors.

Sense and the City

Can you be your own investment manager?

Many people think that successful investment is about hot tips. If someone rings you with a hot tip, ask yourself, 'Why is he calling me?' and put down the phone. If you act on a hot tip from a friend, you may lose a friend and some money. If you act on a hot tip from a stranger, you will just lose some money.

Books tell you how to become rich from stocks. Software programs and training courses claim to help you trade successfully. Their authors assert that, with their assistance, you can make a comfortable living playing the market. Before you succumb, ask the following question: if I had a system that held the secret of lazy riches, would I publicise it in a book from which I will earn – at most – a few thousand pounds? Writing a book is hard work, believe me.

You may already have asked a similar question: why would anyone who could write a book like this one choose to do so? I am one of a minority, perhaps eccentric, who find the study of financial markets intellectually engaging. And I enjoy writing, and hope that you enjoy reading this book as much as I have enjoyed writing it.

My target reader wants to make good returns on investments without worry. He or she probably thinks that managing money

is a chore, and that people obsessed by the stock market are sad. My target reader's financial objective is to have sufficient financial security not to have to worry about money. My target reader would be happy to go on holiday, even for months, and not look at his or her portfolio. My target reader is willing to take risks, but only with small amounts.

My target reader is a retail investor. This is not a technical definition; there are several regulatory classifications of investor provisions that identify high-net-worth investors, sophisticated investors, professional investors. My target reader may be some or all of these things. But by 'retail investor' I simply mean someone who is investing his or her own money. The purpose of this book is to help such a reader become an intelligent investor who can be his or her own investment manager. If you are hesitant about taking on that responsibility, you should, by the end of this book, be able to ask penetrating questions of anyone who offers you financial advice. This book is not for people who want to become professional traders but for those who want to sleep securely, knowing that their portfolio is in the most trustworthy of hands – their own.

A book that told you how to be your own doctor or lawyer would be an irresponsible book. 'The man who is his own lawyer has a fool for a client.' Is it possible to be your own investment manager? The financial services industry attracts many of the smartest people in the country, and certainly includes many of the best-paid people in the country. The City of London is made up of office blocks accommodating thousands of professionals. Traders in the City spend long days dealing in securities, with access to unlimited computing power and extensive data resources. How can you compete with them? You can't, and you shouldn't. But you can hold your own in their world. There are reasons why DIY investing is possible, even necessary, unlike DIY law or DIY medicine.

An obvious and depressing reason for relying on your own

judgement is that most people who offer financial advice to small and medium-size investors aren't much good. A doctor or lawyer may not always get it right, but you can be confident that their opinions are based on extensive knowledge derived from a rigorous training programme with demanding entry requirements. You can also expect that the doctor or lawyer will have real concern for your interests, not just his or her own.

Traditionally, financial advisers were neither expert nor disinterested. People who called themselves financial advisers were salesmen (overwhelmingly they were men) remunerated by commissions and selected for bonhomie and persuasiveness rather than financial acumen. They were financial advisers in the same sense that car dealers are transport consultants. Most of these financial advisers knew little that their customers did not know – except one piece of information which they did not share: how much the adviser would be paid to make a sale.

Things are getting better. Comprehensive regulation of the sale of retail financial services began in Britain only in 1987. As regulators investigated, they found instances of major abuse; the mis-selling of personal pensions and endowment mortgages was followed by the marketing of over-priced and often useless payment insurance (PPI) to millions of customers by salespeople motivated by commissions and targets. Some victims were scammed again by claims management companies which offered to assist in recovering the compensation banks were obliged to pay.

The Retail Distribution Review, implemented from 2013, attempted to clarify the distinction between the independent financial adviser and the sales force, and banned many commission payments, requiring advisers to seek remuneration through clearly disclosed fees. This sits on top of a requirement to 'know your client'; advisers must obtain basic information about their client's situation and needs, and understand key features of the products they sell. Training obligations are more demanding,

although there are still many financial advisers whose expertise has been acquired in the school of life, over a drink, or several.

There is still a long way to go. A 'bias to activity' is intrinsic to the processes of financial advice; few people will pay much to be told to do nothing, even though that is often wise counsel. Training is largely concerned with the process of selling and the mechanics of regulation rather than financial economics. After reading this book, you will understand the principles of investment better than most people who offer financial advice to retail investors. You do not have to worry about 'knowing your customer' if you are your own customer. You need not fear that the advice you give yourself will be biased by the prospect of a fat commission.

You can also benefit from the wider set of opportunities that the internet gives the individual investor. Financial services cannot only be bought and sold electronically, but can also be delivered electronically. From home or office you can now obtain a wide range of information, buy and sell securities very cheaply and access many investment products that did not exist two decades ago. Comparison sites enable you to scan a range of providers.

The internet will never replace the truly skilled intermediary, just as it will never replace the doctor or lawyer, though it may change the roles of these intermediaries. But the search engine and the comparison site can now do much of what intermediaries would once have done. Unfortunately, the search engine and the comparison site are also corruptible. Like the salespeople, they are paid by product providers. What these sites display may not be comprehensive; what they highlight is not necessarily what is best for you.

The divergence between your interests and the interests of those who would sell you financial products is pervasive. One of the oldest anecdotes in the financial world tells of a visitor to Newport, Rhode Island, weekend home of American plutocrats,

who is shown the symbols of the wealth of financial titans. There is Mr Morgan's yacht, and there is Mr Mellon's yacht. But, he asks, where are the customers' yachts? That question is as pertinent today.

For a time I served on the board of the statutory body that paid compensation to retail investors who had lost money through fraudulent or incompetent financial advisers. One such business was run by a flamboyant and persuasive individual who drove a Rolls-Royce and entertained his customers at lavish parties. In the small town in the north of England where he had lived all his life, his extravagant lifestyle was interpreted as evidence of his financial acumen. In a sense, it was: the money received from customers went directly into his pocket and paid for the chauffeur and champagne.

Crude theft is, fortunately, rare in the financial services industry, although some practices came close to what an ordinary person would describe as robbery. But the lawful earnings of many people in the industry seem ludicrous to an ordinary person, and they are. In the course of this book you will learn how activities of little social value are so profitable for the individuals engaged in them.

No complex analysis is required to see that every penny that people take home from the City is derived from fees, commissions and trading profits obtained from outside the City. This is a simple matter of accounting. You and I, and people like us around the world, pay the large salaries and bonuses of people who work in the financial sector. We do so in our various roles as investors, as prospective pensioners, as customers of financial institutions and as consumers of the products of businesses that use financial services.

There may be consolation for British readers in the knowledge that the City of London is a very large exporter, so that much of what the City takes is paid by foreigners. In Britain, even people who do not work in the City benefit from the foreign

exchange earned and the tax paid by City individuals and City institutions, although they also have to compete with City folk to buy houses and hail taxis. This consolation may, however, turn to anger when it emerges that some of the best-rewarded City people pay little or no UK tax – the result of unwisely generous concessions on capital gains tax and liberal interpretation of rules governing residence and domicile.

The massive rewards available in financial services are sometimes defended as the result of competition to attract talented people. The observation is true. The City of London recruits many of the best minds in the country. In my experience, only a few top academics and lawyers rival the best minds in the City for raw intelligence. The mechanism that achieves this result is indirect. Massive rewards attract greedy people. If the number of greedy people is large, then financial services businesses can select the most talented among them. Within the City you find many who are greedy and talented, many who are greedy and untalented, but few who are talented but not greedy. Interest in ideas is generally secondary to interest in money. That is why these people are in the City. So it is, unfortunately, necessary to be suspicious of the motives of everyone who offers you financial advice.

There are people in the financial world whose concerns are primarily intellectual. You will find some in the finance departments of universities and business schools. Others are behind the scenes in banks and financial institutions, where they are described as ‘quants’ or ‘rocket scientists’. Modern financial markets are sufficiently complex, and the relevant analytic tools sufficiently sophisticated, for some people to find observation of these markets interesting for its own sake.

The good news is that the retail investor can take a free ride on all these skills and activities. You can be a beneficiary of the efficiency of financial markets. Efficiency has both a wide and a narrow interpretation. Financial markets, though costly and

imperfect, have proved to be a more effective mechanism for promoting economic growth than central direction of production and investment. But in investment circles market efficiency has a specific technical meaning.

That meaning relates to the 'efficient market hypothesis' (EMH), the bedrock of financial economics. Much of this book will be concerned with the implications of that hypothesis and its limitations. The professional expertise of everyone in financial markets is focused on the value of stocks and shares, bonds, currencies and properties, and on advising on when to buy and sell. These market prices reflect a consensus of informed opinions. The information that Vodafone is a successful company or that the economy of Venezuela is in a mess is known to everyone who trades Vodafone stock or Venezuelan bolivars.

The efficient market hypothesis posits that all such information is absorbed in the market-place – it is 'in the price'. The market is a voting machine in which the opinions of all participants about the prospects of companies, the value of currencies and the future of interest rates are registered, and the result is publicly announced. The corollary of the efficient market hypothesis is that the results of the painstaking research of everyone in the City are available to you for free.

If that conclusion seems startling, and it should, then imagine going to an auction – a fine-wine auction, for example – dominated by professionals. At first, you might be intimidated by the assembled expertise. But if you behave prudently, the dominance of professionals ensures you can't go too far wrong, because their bids will be the main influence on the price you pay.

You may not be convinced by this analogy. You may fear that there will be collusion amongst the dealers at the auction, that the market is rigged against the little guy. You may well be right. Fifty years ago you would have been justified in having similar suspicions about securities markets. But, over recent decades, extensive public resources have been devoted to securing the

integrity and transparency of financial transactions. This is partly because of popular revulsion at corrupt and fraudulent practice, and also because a reputation for honest dealing, or at least more honest dealing than is found elsewhere, is a real competitive advantage in international markets, in which the City trades so successfully.

These regulatory provisions don't work perfectly, and never will. When you trade, your broker must normally secure 'best execution', which means you get the best price available in the market. The reality is that a bank dealing on its own account will often do better. But not so much better. The edge that the skilled and experienced buyer may have can be more than offset by the advantages you have in trading for yourself. You have greater knowledge of your own needs, you know that you can trust yourself. Best of all, you don't have to pay yourself. Your bonus is already in your pocket.

From gentlemen to players

The efficient market hypothesis describes how the market handles information. Information has always been the lifeblood of markets, but the manner in which information is handled has changed. The old City of London was founded on relationships. Who you knew, who you had been to school with, determined how you did business and especially with whom you did business. The City of London was one of the last areas of English public life in which social class played a major role in career advancement and commercial activity.

For the gentleman stockbroker of yesteryear, information meant gossip. The broker would arrive in the office at nine-thirty or ten in the morning to enjoy leisurely conversations with clients, business contacts and colleagues before the alcoholic lunch that was an essential part of the working day. He