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**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.

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

*Second Edition*

*John Kay*

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## Preface

The purpose of this book is to give you the information you need to be your own investment manager. It is a natural companion to *Other People's Money* (Profile and Public Affairs, 2015), which analyses the process of financialisation that culminated in the global financial crisis of 2008. 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 that 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 bookmarks 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 only modest royalties? Writing a book is hard work, believe me.

You might 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 private investor, a term by which I simply mean someone who is investing his or her own money, or would like to do so. 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 in the knowledge 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 smart people, and certainly employs many of the best-paid people in the world. Financial centres accommodate thousands of professionals. Traders 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 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.

In some ways, things are getting better. Regulation has driven many ill-equipped financial advisers from the market. The large conglomerates that dominate the finance sector spend billions of dollars on training and regulatory compliance. But at the same time they have been obliged to pay billions of dollars in fines and compensation to people whose trust they have abused. The Dodd–Frank legislation in the United States, and the consequent establishment of the Consumer Financial Protection Bureau, have given new emphasis to the interests of customers, although these measures have been vigorously resisted by industry lobbyists. In Europe, however, the extensive new rules introduced since the global financial crisis of 2007–8 are as much aimed at protecting established financial institutions as at protecting their customers.

So 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 and compliance are 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 the internet has given the individual investor. Financial services can not 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 sales people, 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? The question is as pertinent today.

A sideshow of the global financial crisis was the exposure of some of the largest frauds in history. Bernard Madoff and Allen Stanford, who had each stolen billions of dollars from their customers, ended up facing extended terms of imprisonment. Such crude theft is, fortunately, rare in the financial services industry, although many practices came close to what an ordinary person might describe as robbery. But the lawful earnings



of many people in the industry seem ludicrous to an ordinary person, and 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 finance is derived from fees, commissions and trading profits obtained from outside finance. 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.

The massive rewards available in financial services are sometimes defended as the result of competition to attract talented people. The observation is true. Finance recruits many of the cleverest graduates from leading universities. In my experience, only a few top academics and lawyers rival the best minds in finance 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 finance 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 finance. 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 private 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, 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. Market prices reflect a consensus of informed opinions. The information that Apple builds great products or that the economy of Venezuela is in a mess is known to everyone who trades Apple 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 financial sector 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 among 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.

These regulatory provisions don't work perfectly, and never will. When you trade, your broker must normally get you 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 life-blood of markets, but the manner in which information is handled has changed. Finance was once based on relationships: the community bank manager, the locally based insurance agent and the gentlemanly stockbroker knew their clients, often socially as well as professionally. Investment bankers nurtured a long-term association with big and small companies, investing time in acquiring knowledge of the business, in the expectation that they might occasionally be rewarded by commission on a new issue or fees on an acquisition.

The atmosphere of today's financial markets is very different. Most stock exchanges no longer have a trading floor where buyers and sellers meet. Now, the large investment banks have