the reading room
the four pillars of investing

By William Bernstein
McGraw-Hill (2002)
300 pages

review rating
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Following up a well received but quite technical book on asset allocation, Bernstein has written a no-nonsense guide for the average investor. Whilst written primarily for the US environment, the book contains significant general insights and information about other markets that make it an excellent read for any serious investor.

Bernstein maintains that any investor needs to be aware of the “four pillars” of investment which he describes as:

The Theory - The most fundamental characteristic of any investment is that its return and risk are inextricably related. A stock or bond is a claim on real future income or assets. There is virtually no evidence that professional money managers can outperform the market over the longer term and absolutely no evidence that anyone can time the market. Asset allocation is the major determinant of overall return. It will be a function of your tolerance for risk, complexity and volatility. Define a strategy and stick with it, rebalancing as required, and manage all your financial assets as a single, but diversified, portfolio. Past performance is only weakly predictive of future behaviour so don’t design your portfolio on the basis of the past decade or two.

The History – A study of financial history, particularly previous manias and crashes, will provide the investor with an additional dimension of expertise, that is how to recognize then avoid the mistakes associated with “boom/bust” cycles. Booms are usually initiated with the arrival of a revolutionary technology or significant change in financial methods/ analysis, easy credit and “memory fade” (typically occurring about a generation apart). The major benefactors of new technologies are the users rather than the inventors so the returns to technology investors are typically low especially on IPO investments.

The Psychology – Learning how to avoid the most common behavioural mistakes is vital. Bernstein illustrates a variety including: herd mentality (popular investments are likely to be overpriced), overconfidence (you are usually trading with investors who are more knowledgeable, faster and better equipped - how can you consistently win ?), recency (past years losers will often be future years winners), the need to be entertained (excitement/ speculation), myopic risk aversion (focus on short term losses), great company illusion (the dullest companies tend to have higher returns than the most glamorous ones), pattern hallucination (the search for patterns is not only futile but dangerous) and mental accounting (we are less likely to sell losers than winners).

The Business – Understand how the investment industry operates or “pay the price !” Your stockbroker does not have the same goals as you – they are transaction/commission oriented, turnover is king (capital gains tax is an unfortunate byproduct) and their stock analyses/recommendations may often be influenced by “in-house” allegiances despite disclaimers. At least their fee structures are relatively transparent compared to the managed fund market. Beware the hidden fees, the expense ratio (MER) is just the tip of the iceberg. Take everything you read about in the financial pages with a grain of salt. Financial journalists need to write interesting copy (“Fund Manager of the Year” stuff) rather than “boring” analysis

Bernstein says a coherent strategy can only be formulated once the investor has mastered the four pillars. Short term returns cannot be predicted but over the long term stock market returns will approximate the dividend yield plus the dividend growth. The current high price and low dividend rate of US stocks suggests that they will have lower returns than in the past which should be taken into consideration for asset allocation. Even for the most aggressive investor he suggests a maximum of 75% to 80% in stocks. Bond portfolios should be short term (maximum duration of 5 years).

Stock portfolios should look at diversification in terms of domestic v international, large cap v small cap, value v growth and the some consideration might be given to the use of “alternative investments” including REITs (property trusts), precious metals, private equity, hedge funds, etc. The book strongly recommends the use of index managed funds as the core to a portfolio owing to their low cost nature. In the USA there is a far greater variety of index funds and they cover most individual asset classes and sub-classes (eg small cap value stocks) so tailoring a portfolio is easier. In Australia Barclays Global Investors and Vanguard provide index funds for the major asset classes but Dimensional is the only passive Manager to provide for “value” and size sub-classes, and these funds are only available via an advisor. The record shows that value stocks clearly outperform growth stocks over the long term.

In summary Bernstein believes that analysis of the historical data shows that it is almost impossible to beat the market consistently over the long term (by active management or timing) and therefore suggests to avoid stock picking – at least in the efficient US market.

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