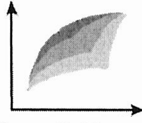
Efficient Frontier



William J. Bernstein

The Probability of Success (Or, Confessions of a Personal-Finance Writer)

Having spent nearly a decade writing about investment management for the little guy, I have come to the conclusion that I no longer believe in the basic premise of my public persona—a surreal cross between Harry Markowitz and Johnny Appleseed, as a friend put it.

A decade ago, I really did believe that the average investor could do it himself. After all, the flesh was willing, the vehicles were available, and the math wasn't *that* hard.

I was wrong. Having emailed and spoken to thousands of investors over the years, I've come to the sad conclusion that only a tiny minority, at most one percent, are capable of pulling it off. Heck, if Helen Young Hayes, Robert Sanborn, Julian Robertson, and the nation's largest pension funds can't get it right, what chance does John Q. Investor have?

Why the sad state of affairs? It's pretty simple. To invest competently, you need four faculties:

- An *interest* in investing. It's no different from cooking, gardening, or parenting. If you don't enjoy it, you'll do a lousy job. Most people enjoy finance about as much as Carmela Soprano enjoys her husband's concept of marital fidelity.
- The horsepower to do the math. As Scott Burns explained to me years ago, fractions are a stretch for 90% of the population. The Discounted Dividend Model, or at least the Gordon Equation? Geometric versus arithmetic return? Standard deviation? *Correlation*, for God's sake? Fuggedaboudit!
- The knowledge base—Fama, French, Malkiel, Thaler, Bogle, Shiller—all seven decades of evidence-based finance back to Cowles. Plus, the "database" itself—a working knowledge of financial history, from the South Sea Bubble to Yahoo!
- The emotional discipline to execute faithfully, come hell, high water, or Bob Prechter. Mr. Bogle makes it sound almost easy: "Stay the course." Alas, it is not.

I expect no more than 10% of the population passes muster on each of the above points. The devastating part is, to succeed *you need to string all four together*. Thus, in a state of nature, just 0.01% of investors have what it takes. An optimist might guess a 30% success rate on each count, in which case one percent of the population can make all four.

Perhaps I overstate the case. After all, these four abilities are not entirely independent: if you're smart enough, it's more likely you'll be interested in finance and be driven to delve into the appropriate finance literature. But even if true, more than a little luck is involved. Head down to the personal-finance section of your local Barnes and Noble, and you're more likely to run into Suze Orman than Jack Bogle. You'll need a telescope to find the really important stuff. Worse, I'm here to tell you that the last condition—the ability to deploy what Charley Ellis calls "the emotional game"—is completely independent of the other three. I wish I had a nickel for every smart, savvy, and motivated financial type I've met who simply could not execute.

There are exceptions. Come to a Vanguard Diehards meeting and you'll think there is hope. Then travel a few feet down the hall where the gurus of the month are holding forth and you're quickly brought back to reality.

Call Me Vladimir Illych

In my opinion, about the only way to disseminate financial competency among more than a few percent of the population would involve totalitarian methods—establishing an Efficient Markets Propaganda Ministry. Investment reeducation camps would be set up for the likes of Jim Glassman, Abby Cohen, and the Beardstown Ladies, featuring several hours per day of remedial math and statistics.

Short of that, the Forces of Darkness will remain ascendant. It cannot be any other way. In a society with an increasingly abbreviated attention span and burgeoning innumeracy, the logic of asset-class-based passive investing has about as much appeal as the vegetarian buffet at a cattleman's convention. There is no place for CNBC and 95% of the nation's financial journalists in the World According to Bogle.

Of course, I'm not recommending the establishment of efficient-market martial law, administered with an iron fist from Valley Forge, Chicago, and Santa Monica. Rather, I'm pointing out that in a liberal democracy, the overwhelming majority of the population will always invest incompetently. Our society pays many costs for our precious civil liberties; this is surely one of the smaller ones.

The good news is that this increases the rewards to those who make the effort. After all, in a world where everyone knows how to calculate realistic expected returns, eschews high expenses, and trades little (and then only concavely), the marginal reward for doing so is low.

The main purpose of this exposition is not to consider how we can increase aggregate investor competence. This is a process so glacially slow that the grim reaper easily outruns it. Take a look around after every bubble and you'll find that the only investors left reasonably intact have gray hair.

Rather, I want to focus debate on just *who* should be running the nation's investment pools. An overriding concern for public safety mandates that those commanding the nation's airliners, nuclear power plants, and military hardware obtain and maintain a precisely defined degree of competence. We should demand no less of those managing the country's retirement portfolios. The events of the past few years underline the bankruptcy of the notion that every worker can be his or her own portfolio manager. The default option for retirement accounts should be a professionally managed low-cost balanced approach, preferably passive. Only those who can demonstrate competence in evidence-based finance should be *licensed* to drive their retirement vehicles on the public highways of our capital markets.

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