FRED SCHWED'S

WHERE ARE THE CUSTOMERS' YACHTS?

A MODERN-DAY INTERPRETATION OF AN INVESTMENT CLASSIC

BY LEO GOUGH

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INTRODUCTION

In 1940 Fred Schwed, a stockbroker whose father had lost everythin as a short seller on Wall Street during the Roaring Twenties published this timeless classic on how the stock market really work Schwed, a pleasure-loving, cultured man who had been expelled fro Princeton University in his final year for entertaining a lady in hi room after 6pm, had a deep understanding and few illusions abou the world of investment. He had seen the ups of the 1920s boom an the downs of the 1930s Depression, and his insight into th psychology of investment professionals and their customers is a relevant today, in the current financial crisis, as it was in 1940.

The title of his book, *Where are the Customers' Yachts?*, refers to an old joke: a tourist is being show all the fancy boats in the harbour, and is told, 'These are the bankers' yachts, and these are th stockbrokers' yachts.' When he asks, innocently, 'Where are the customers' yachts?' he is told tha there aren't any (in other words, the customers have not got rich from the stock market).

Schwed is very far from being a cynic, however. He is not saying that investment is pointless, or th private investors never make any money. Rather, he is casting doubt on the ability of the financi services industry to provide any really valuable advice to its customers.

In recent decades great strides have been made in the theoretical understanding of financial market but Schwed's wisdom, developed long before the days of hedge funds and exotic derivatives, sti holds true. There's a humorous gem on almost every page that strikes a very familiar chord, from th story of the highly paid economist who lugs huge briefcases full of documents to conferences (b never opens them), to the gentle dig at the tendency of analysts to 'develop a prose style which wou make a nineteenth century German metaphysician envious'.

Fred Schwed had 'a sneaking fondness for that wretched old hag, the capitalistic system'; in his vie it's much better than the alternatives. His central point is that markets are unpredictable. That doesn matter if you're investing for the long haul, because all the major stock markets perform well in th long term – it's trying to do better than average, says Schwed, that causes all the trouble.

The follies, the frauds, the fads and the scandals of today are remarkably similar to the ones in Fr Schwed's day. That shouldn't come as a huge surprise, when you read the way that this charmin sophisticated writer deals with the issues of the 1930s and 40s, the truth of the axiom that peop never seem to change really hits home. As Michael Lewis says in his foreword to the 1995 edition,

like to think that when I first stumbled across this delightful little book the ghost of its auth ~~stumbled right along with me, with a gin and tonic in his hand.’ Reading Schwed’s book~~ is lik meeting a friend, and it’s a great feeling to realise that not everyone in the markets, then or now, is money-obsessed barbarian.

1 INCREASING YOUR SAVINGS INCOME – THE WRONG WAY

‘Suppose that a family has $100,000 invested in conservative bond yielding $3,000 a year: … perhaps the time comes when the famil feels they can no longer hold their heads up … unless little Paula goe to a fashionable finishing school. For that it will be necessary to jac up their income yield to $5,500 … Their investment man … ca arrange the larger yield in a jiffy … He simply sells out th conservative bonds and substitutes riskier securities.’

Fred Schwed goes on to point out that what Paula learns at finishing school may turn out to be all s has to face life with, if the family’s capital is lost in the riskier securities.

DEFINING IDEA…
Distrust and caution are the parents of security.
~ BENJAMIN FRANKLIN

These days, the people who try to live on their investment income are generally already retire Anyone who can work is usually advised to reinvest their investment income, and not to spend This is sensible advice, and it applies to able-bodied retired people too. If you don’t have spend your investment income, don’t do it! By adding it to your capital, you will help it to gro which will potentially give you a larger investment income in the future.

What is really fatal is to try to increase your income by putting your nest egg in riski investments. British government bonds, for instance, are less risky than, say, Indonesi government bonds. Even before the current financial crisis, it was clear that the high street ban in Britain were likely to be a safer place to deposit money than, say, Icelandic banks, becau Britain is a larger and stronger economy than Iceland. The market is aware of these differences risk. That’s why Indonesian bonds offer a better return than UK government bonds, and w Icelandic banks were offering a better interest rate to depositors than British banks did before t crisis of 2008.

Most of the time, if there are two similar investments and one offers a better return than t other, it is because it is a riskier investment. No one really knows exactly how much riskier it i of course, but if you are trying to keep your capital as safe as possible so that it can go on payi out an income for many years into the future, don’t increase your risk, and DON’T move yo capital into riskier investments!

HERE’S AN IDEA FOR YOU…

At the time of writing, interest rates are lower than they have been for generations. The pundi keep telling us that this is good news for borrowers and bad news for savers. If you are living c your investment income, though, you will have been enduring low fixed income rates for man years already. Yes, they are even lower now, but don’t succumb to the temptation of investing i riskier things in order to increase your income. Look for other ways of coping, such a tightening your belt, getting a part-time job, or selling a few things you have in the hous Interest rates will go up eventually – your objective must be to preserve your capital, and the be way to do that is to keep it in the safest assets you can find, even though they don’t pay the be rates.

2 SPECULATION

‘Speculation is an effort, probably unsuccessful, to turn a little mone into a lot.’

DEFINING IDEA…
There are two times in a man’s life when he should not speculate: when he can’t afford it, and when he can.
~ MARK TWAIN

Much is made of the difference between investment (a ‘sensible’ activity) and speculation ‘risky’ activity) but, as Schwed points out, it is not always easy to tell the difference between th two. Plenty of cautious investors have lost money in what they thought were safe investment sometimes through skulduggery but more often because the investments turned out not to b quite as safe as all the experts thought they were. So you might say that investments that we generally thought to be safe but actually resulted in losses should be classed in the speculativ category. This doesn’t help us much though, because as investors we need a definition that ca help us make decisions about the future; just saying that all past loss-makers were speculativ doesn’t tell us anything useful.

To understand speculation, you need to understand human nature. It is very natural and human get excited and confident when you have made some money easily and it looks as if you a going to make a lot more even more easily – that’s how the psychology of booms works, whe even normally cautious people start plunging into riskier and riskier investments. But re speculators, the people who are just naturally inclined to take large risks, are different: they wi speculate whatever the market is doing, whether it is going up, down or sideways.

Beginners at stock market investment often try their hands at speculation. This is unwise, becau they don’t understand the market very well. Typically, beginners think, ‘If I can pick a fe winning shares, I can sell out when the price goes up and make a quick profit.’ The odds a against them, for two main reasons. First, there is very good evidence that no one, even th experts, is much good at picking winning shares consistently. The famous exceptions to this rul such as Warren Buffett, are discussed in chapter 37 (basically, they improve their odds usin methods that are not available to the ordinary investor). Second, most beginner investors have n idea how to evaluate a particular company or to assess the risks of a given investment.

Is speculation always foolish, and will it always end in tears? Not necessarily. For example, you have better knowledge than others about a particular investment or situation, you may judg that it is less risky than other people realise. As a speculator, you look for opportunities whe there is a high reward to risk ratio; if you can find them, you’ll make money. In the major stoc

markets, however, such opportunities are rare – to find them, you'll have to go further afield,
developing countries or outside the stock market altogether.

HERE'S AN IDEA FOR YOU…

The stock market is a game that is designed to foil speculation. If you really want to take larg risks and be able to influence the outcome of your investment, you would be wiser to try yo hand at a real business; if you choose the right business and run it well, your chances of makin large profits are generally better than if you speculate in the stock market.

3 SHARE PRICES DON'T ALWAYS GO UP

'[The SEC] not only want an orderly market, but a market that sha forever gently rise. Of course, that conception is just plain silly, lik Voltaire's suggestion that a community ought to be able to suppor itself by everybody taking in everybody else's washing.'

To someone new to the stock market, it might seem quite a good idea for the government to make su that share prices always go up. It could pass laws to that effect. Then it could make the regulato body – in the US, this is the SEC (Securities and Exchange Commission) and in the UK, it is the FS (Financial Services Authority) – force the market to nudge up share prices by a small fraction, sa once a month. After all, wouldn't most investors be happy with a small profit every month?

DEFINING IDEA…
It is difference of opinion that makes horse races.
~ MARK TWAIN

The idea is completely unworkable, of course, and the regulators know it. What Schwed complaining about here is that regulators are pressurised, especially in times of crisis, to mal pious and reassuring statements about the market to the public. Today the public is mo knowledgeable about investment than it was in Schwed's day, but not by much; it is sti extremely poorly informed about the stock market and economics in general, and it wants to l told that the government will make everything all right. But that's not how markets work.

To be attractive to investors, a stock market depends upon its ability to allow investors to buy ar sell shares at any time when the market is open. On large stock exchanges, like London and Ne York, millions of shares exchange hands every day, and the share prices are always changir (usually by only a tiny fraction). But in order to sell your shares, there has to be a buyer, and if government stepped in to force prices up artificially, there would come a point when there wou be no buyers: the price would be too high. People would start looking for other ways to invest ar billions would drain out of the market and go overseas to other stock exchanges.

To function properly, a stock market has to allow prices to fall as well as rise. That's wh investors really want. If Megaboom Plc loses billions and comes near to bankruptcy, you wou want to see those losses reflected in its share price, wouldn't you? If you wouldn't, then dor become a stock market investor!

But why would anyone sensible buy Megaboom's shares if they dropped? Simple: it's becau

they think that the shares have gone down too far, and that Megaboom's business will recove
That's a matter of opinion – and that's what drives the market.

HERE'S AN IDEA FOR YOU…

In the long term, on average, share prices in the world's stock markets do rise, and at a bette rate than other kinds of financial assets, such as bonds or cash deposits. To take advantage o this, most experienced investors put a lot of their money into carefully selected unit trusts ar investment trusts. If you decide to do this, make yourself this promise: you won't touch the mone for a minimum of five years. This will increase your odds of a satisfactory outcome.

4 THE FUTURE OF INVESTMENT

‘Investment is an effort, which should be successful, to prevent a lot o money from becoming a little.’

Usually we think of investment as a way of making our money grow. So what does Schwed mean b saying it’s really a way of protecting our money from shrinking?

DEFINING IDEA…
Castles made of sand slip into the sea eventually
~ JIMI HENDRIX, MUSICIAN

To understand this, think about a very long period of time – say 2,000 years. Do you think would be possible to grow your wealth consistently and pass it on to your descendants for such long period of time? It has probably never been done, although some people, like the Norma nobles, did try to preserve their wealth by passing it on to the first son in each generation. doesn’t work. First, your direct line may die out. If your direct line of descendants doesn’t d out, you would probably have so many descendants that the wealth would get diluted (th happened to the wealthy Vanderbilt family in less than 150 years). Furthermore, the structure that allow safe investment – like nation states, property laws, banking systems and so on – dor last that long. Over the last 2,000 years there have been many times when violent political chang has caused the wealthy to lose everything – think of Genghis Khan’s invasions, or the Russia Revolution.

If that doesn’t convince you that wealth cannot be kept indefinitely, consider this: if you had bee able to deposit, say, £10,000 in a bank at 5% interest in the year 1 ad (which you couldn’t hav because there weren’t any banks), compound interest would have built your deposit up so that would now be worth more than all the money in the world.

All this may sound ridiculous, but there is a serious point: investment, as we think of it today, h only really existed since the nineteenth century. In our own time we have seen a gre democratisation of investment, as more and more people have gained access to the mone economy, bank accounts, the stock market, and so on. Our investment survival depends upon th financial system remaining stable in the future. Yes, the system may well outlive us, but can w really be sure it will be there in 300 years’ time, say?

This insight should inform our strategy. Knowing that we cannot build up wealth that will last f centuries, we should focus on building up enough to keep ourselves in our old age and a sum th we can pass on to our children to give them a start in life. If we are lucky enough to have attain that much wealth early in life, it will be a full time job to preserve it. That’s because society has

way of chipping away at large fortunes until there is nothing left. Remember all those Edwardia
gentlemen of leisure, who didn't have to work for a living? Most of their descendants have had
get regular jobs.

HERE'S AN IDEA FOR YOU…

*You may not be able to pass your wealth on to your descendants in 4010, but you can pass it on t
your children. Make a will – and appoint trusted friends, not lawyers or bankers, as executor
That way, you'll keep expensive professional fees to a minimum.*

5 BOOMS GO 'BOOM'!

'In our moment of sober thought we all realize that booms are ba things, not good. But nearly all of us have a secret hankering fo another one.'

Fred Schwed lived through the Roaring Twenties, when middle class people in America had a whale a time, dancing the Charleston, drinking illegal booze, and making easy money as the stock mark soared. Then he had to endure the grim days of the Great Crash of 1929 and the years of the Gre Depression of the 1930s.

DEFINING IDEA…
We will never return to the old boom and bust.
~ GORDON BROWN IN 2007,
JUST BEFORE THE 2008 BUST

At the time of writing, we are in the midst of a global financial crisis that has followed a lo boom in easy consumer credit. A lot of people are hoping that the boom days will come bac soon. It's easy to understand why: when it was easy to borrow large sums, house prices soared the UK. The higher the house price, the easier it was to release large chunks of spending mon by remortgaging. And money was cheap, by historical standards (at the time of writing money still very cheap in the UK, but this is unlikely to last for long and in any case it is hard borrow). There are many people who are young enough to have first entered the house mark during the boom, and whose only experience, until the present crisis, was of easy money a rising prices. They don't remember the long, miserable periods in the past – like the times wh inflation was over 20%, or when almost nobody could get a mortgage, or when young peop couldn't get any kind of a job. And even if you are old enough to remember those bad times, y would probably prefer not to.

The fact is, there are good times and bad times in economic life. They are often called cycles, b they are not very regular or predictable cycles. One of the main secrets of economic survival not to behave as if a boom is going to last forever – they never do. When the crash comes, it's t people who have borrowed too much who get hit the hardest.

Money will probably be tight for a long time. Wages probably won't rise much, and jobs will b hard to find. You won't be getting 15 invitations to get a new credit card dropping through you door every week. The word 'shopaholic' will begin to seem quaint and old-fashioned.

Never mind. It's not the end of the world. Focus on the productive aspects of your life, li building your career, saving, and paying your mortgage, and muddle through; one fine day you'

start to notice another boom beginning. You'll probably make a fool of yourself in that boom too, but just try to make sure you keep it within sensible limits.

HERE'S AN IDEA FOR YOU…

If you borrow, try to borrow for constructive purposes, like buying somewhere to live, or a car to get you to work, or good clothes that will help you get a good job. That's 'good' debt. 'Bad' debt is when you borrow money at high rates of interest (for example by using store cards or credit cards) and spend it on things you don't need. Pay off those cards!

6 PROFESSIONAL STOCK-PICKING

‘Thus far in our history there has been little evidence that there exist a demonstrable skill in managing security portfolios.’

DEFINING IDEA…
I have no confidence in professional stock-picking.
~ PROFESSOR ALFRED STEINHERR, EMINENT BANKER

In spite of all the hype, the grand offices, the PhDs in finance, the serried ranks of bright your professionals and the genuine advances in the theoretical understanding of finance ar investment during the last half century, it is still as true today as it was in Fred Schwed’s th professional managers, as a group, have not demonstrated that they can consistently perfor better than the average over an extended period of time (for an explanation of what ‘averag may mean see chapter 13).

It should be said though, that professional fund managers in general are probably better managing security portfolios than you are, at least when dealing with technical matters. They a less likely than the average person to make a silly mistake, like buying the wrong shares, which easy to do when a company has more than one kind of share in issue, or like invalidating a sha application form by filling it in incorrectly. We can reasonably expect them to a ‘professionally’ in the sense of performing their duties to a good standard. But this is not at a the same as having a special skill in knowing which shares to buy, or when to buy and sell ther No one has the ability to always pick shares whose prices will go up.

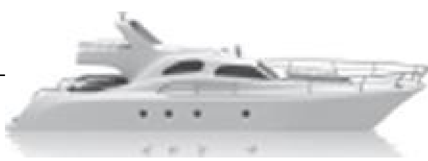
This insight has been confirmed by numerous studies of the performance of professional managed funds. In general, the majority of funds perform worse than the market as a whole, ar even the funds that do outperform the market generally are unable to keep it up for many year There are a few exceptions, of course, but statistically we would expect there to be a fe exceptions as the result of chance.

In recent years Americans, who are generally a bit more clued-in about the stock market than v are in Britain, have become rather fed up with this state of affairs. Why should a private investo they ask, pay for expertise in stock-picking when it is not clear that such an ability really exist Some market professionals respond vigorously by arguing that some talented people do seem be very good at stock-picking, at least on the face of it. But there aren’t very many of them, ar often their funds are rather large and overpriced, so they won’t necessarily perform particular well in the future.

This is the great problem of investment. The really big gains are generally made by a stoc picker who is not very well-known. Once the stock-picker becomes famous everyone watch him or her like a hawk, and the returns tend to go down as competitors start to copy the methoc To be successful, a stock-picking method must be both inherently sound and unpopular.

HERE'S AN IDEA FOR YOU…

Tired of less than exciting fund performance? Why not pick a tracker fund, which simply mimic the performance of a stock market index. It will probably slightly under perform the index, b not by much, and you'll probably do a lot better than most fund managers! You can find tracke funds quoted in the financial press.



7 SPEND YOUR INCOME, NOT YOUR CAPITAL.

'A man's true wealth is his income, not his bank balance. There ar times and places when it is better to have a hundred thousand dollar than it was to have had two hundred thousand at another time an place.'

DEFINING IDEA…
A large income is the best recipe for happiness I ever heard of.
~ JANE AUSTEN

The main point here is that it is your current income, not your total assets, and especially n your financial assets, that governs your lifestyle and how wealthy you feel. The purchasing pow of your money may vary from time to time, but you should try to avoid drawing down capital spend as if it were income.

Many of us don't have much in the way of assets, so we fail to appreciate this importa difference. To someone with no assets, all money looks like spending money. But capital - whic means your valuable possessions, like houses, cars and pension funds - is hard to acquire a easy to lose, so it is very important to make the distinction between money you need to keep, a money you can spend.

To understand the difference, consider the following example:

First, let's imagine Fred, a supermarket shelf stacker who wins 5 million quid on the lottery. Th first mistake he makes is to tell all his friends and relatives. A lot of them will automatical expect a handout, which will whittle away at his lump sum. Next, he decides to be sensible a buys some houses for himself and his relatives. That's fine, but he probably buys houses that a quite expensive to maintain. Next, he gives up his job - that would be fine if he was going to tra to get a better job, but no. He goes off on a series of world cruises with his mates, drinks a lo and gets into bad spending habits. When he finally gets home, he buys a lot of expensive spor cars. A few years down the line, he's a bored, lazy good-for-nothing. After a while, th champagne lifestyle, the upkeep of the houses and cars, and all the loans he has to make to h fair-weather friends, start to bite. Pretty soon Fred finds that he will have to get a job in order maintain his lifestyle, but any job he can get probably won't generate enough money. Slow some of the cars have to go. Then maybe the houses will have to go too. It's an old story, but happens quite often. It is amazingly easy to get through millions of pounds in only a few yea and have little or nothing to show for it at the end.

What Fred should have done, of course, from a financial point of view, is to have said, ‘This million quid is capital, not income. I’m going to invest it and live off the income.’ At 4%, sa his capital could have given him an income of £200,000 per year for the rest of his life, far mo than most people earn or need.

HERE’S AN IDEA FOR YOU…

Next time a lump sum falls into your lap, leap into action and DON’T spend it! Put it away in bank deposit, bonds or shares, and leave it to grow.

8 CAPITAL MARKETS

‘We all have a fondness for articles which can only be produced i plants costing millions of dollars. Few of these articles can b produced by a fellow and his uncle working behind the garage. Th only successful method so far devised for getting millions out of th public, for enterprises good and bad, is some system similar to th devious mechanisms of Wall Street.’

DEFINING IDEA…
Capitalism is what people do when you leave them alone.
~ KENNETH MINOGUE, POLITICAL SCIENTIST

If you really want to understand the stock market, think about it from a company’s point of vie Companies need money in order to function, to make profits, and, especially, to grow bigge They can get money in three main ways. First, they can reinvest their profits. This is a nice, sa way that is appropriate for some types of business, but its disadvantage is that it severely limi the rate at which the company can grow. If you have a new product that will potentially make fortune over a period of, say, five years, reinvesting your profits will not enable you to grow fa enough to enable you to take full advantage of your market opportunity. In today’s cut-thro business world, you’ll be pushed aside by a better financed company and wind up with only small share of the market. This often happens to small companies.

The second way to get money for growth is to borrow it. This isn’t a bad way, but you have to pa interest, and you’ll have to convince a bunch of glassy eyed, unimaginative bankers that yo project is likely to succeed.

The third way is to raise money by selling shares in your company to investors. The ne shareholders become, in effect, sleeping partners in your company, enjoying any increase in th value of the company and also receiving dividend payments that you make out of the profits. your company is large enough, this can be done by selling shares to the general public through stock market. It is not an easy or cheap process, but if it is properly done it can raise massi amounts of capital for your enterprise relatively quickly, so it is a great way to finance growth.

This is the basic reason for the existence of the stock markets. It is a way of matching savers, lil you and me, with productive organisations, like successful companies.

HERE’S AN IDEA FOR YOU…

The great advantage of the major stock markets is their liquidity. You can sell most shares at an time that the market is open. Compare that with the situation when some friends ask you to bu shares in their small business; you may never be able to sell the shares and get your money bac It is the liquidity, and relative stability, of most publicly traded companies that make stoc market investing more attractive than small company investing to most people. In some countrie particularly in the Far East, many people keep large sums of money in the bank permanently s that it remains liquid. This is unwise - they would get a better return in the stock markets. If a your savings are in cash or bonds, think about putting at least some of it in the stock market – will still be liquid.

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