From Enron to Bear Stearns: Will Investors Ever Learn?
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This week following a CalCPA continuing education meeting I had an interesting visit with a Merrill Lynch broker friend. He told me about an acquaintance of his who is, or should I say was, an Investment Banker with Bear Stearns. I could hardly believe my ears when he told me that the Investment Banker had literally 100% of his investment assets invested in Bear Stearns stock. As I am sure you know by now if you listen to any news broadcasts at all, Bear Stearns stock was selling for $171 per share in the first week of January 2007[1] and this week a deal was struck for JP Morgan to buy Bear Stearns for $2 per share, that is a loss of 98.8%, about as close as you can come to "losing it all" without actually losing it all.

It has only been seven years since Enron went bust and many of the 22,000 employees who "drank the cool-aid" and had all their retirement money in Enron stock lost it all. Everyone knows about the Enron debacle; even people who have never bought a stock in their lives. But did anyone learn the lesson of Enron? I don't mean the one about not cheating in the Board Room, but the one about safety in diversification or put another popular way, "not putting all you eggs in one basket". Apparently this Investment Banker and his Bear Stearns Advisor didn't learn.

Why would someone do what is now obviously such a stupid thing? Well, if you had an investment that since 1985 had outperformed the S&P 500 Index and even beat Warren Buffet's Berkshire Hathaway, would you be tempted to depart from prudence and overload into that investment? That was the story with Bear Stearns. It was a great ride up and a horrific crash, one of historic proportions. Greed set in and greed did what is most often does, it destroyed the one's who courted it. Too many investors are controlled by two powerful emotions, greed and fear. These are two of the greatest enemies of successful long term investing. The antidote is an understanding of how the markets work and the discipline to invest in a sound strategy.

Markets Work.

Academic research makes it clear that financial markets around the world are essentially efficient, that is, all public information that can be known about a stock is known by market participants and stocks are priced accordingly, that is, the price is essentially always correct. The implication of the Efficient Markets Theory is that it is a futile effort to try to pick stocks or time the markets in order to "beat the market." I won't argue about whether or not the markets are perfectly efficient, they probably aren't. However, the question for an investor is, "Is there enough inefficiency in the market so I can profit from it?" All academically sound studies I have seen answer that question with a resounding NO!

Risk and Reward Are Related.

Most people understand this at its most fundamental level; in order to have more reward, you must take more risk. In other words, risk is rewarded – but not all risk. Bear Stearns

[1] *Yahoo! Finance. http://finance.yahoo.com.*

is but the latest example. I will address this in my next point. Equities (stocks) are more risky than fixed income (bonds). The value of a dollar in 1927 invested in Large US Stocks was worth $3,286 at the end of 2007. That same dollar invested in US Bonds was worth $76 at the end of 2007. During that 80 year period there was much more volatility (risk) with stocks than with bonds. Also, if one invested their $1 in small US Stocks instead of Large US Stocks that dollar would have become $16,643 instead of $3,286. Additionally, if one had only invested in Large US Value Stocks, that $1 would have become $14,517 instead of $3,286. Small Stocks and Value Stocks were more volatile (risky) than the Large US Stocks – and, they paid off with greater return.[2]

Diversification.

Portfolios that are structured to provide comprehensive asset class allocation both domestically and internationally have the advantage of only taking the risk of the market, not the individual business risk of a Bear Stearns or an Enron. Consequently, the diversified portfolio is "safer" and will over time outperform.

Structure Determines Performance.

Asset Allocation explains most of the variation in portfolio returns. What do I mean by Asset Allocation? I mean how much of those Large US Stocks, small US Stocks or bonds will I place in a portfolio. Actually, there are more well-defined dimensions of the market like US Large Value Stocks, US Small Value Stocks, International Value Stocks, Emerging Market Stocks, Emerging Market Value Stocks and Emerging Market Small Stocks as well as various kinds of bond investments. A fully diversified portfolio will have some amount of all of these "asset classes" in a proper recipe that maximizes return for a given level of risk. This is the essence of what is known as Modern Portfolio Theory.

So, what are the lessons to be learned here?

1. Capital Markets do work, but a limited number of holdings are not required to reward you with Capital Market returns. You might just own a few Enrons and Bear Stearns', and for a while take a magic ride on the flying carpet but may eventually fall off the carpet from significant heights and find out that it hurts to fall from so high – so diversify.
2. Take only as much risk as you can afford to take both emotionally and financially. Some people are emotionally risk takers but their financial condition says they can't afford to take as much risk as their intestinal fortitude will allow. Even a diversified portfolio has risk and it should be appropriate for you.
3. If you don't know how to structure an investment portfolio in a scientific way, then hire a fee-only CFP® Practitioner or other qualified professional who can. What you spend in fees will probably be far less than what you would lose by

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[2] *Sources: Small Company Stocks is CRSP 9-10 Index and is provided by the Center for Research in Security Prices, University of Chicago. Large Company Stocks is S&P 500 Index and is provided by Standard & Poor's Index Services Group. Large Value Company Stocks is Fama/French Large Value Research Index and is provided by Fama/French. US long-term bonds, bills, inflation, and fixed income factor data ©Stocks, Bonds, Bills, and Inflation Yearbook™, Ibbotson Associates, Chicago (annually updated work by Roger G. Ibbotson and Rex A. Sinquefield). Data used reported from 7/1926-12/2007.*

trying to be a non-professional do-it-yourselfer. In all likelihood, you will come out far ahead over time by associating yourself with a truly qualified professional who acts in a fiduciary capacity on your behalf.

You can have a pleasant investment experience over time if you follow academically sound principles of investment.

Charles L. Stanley CFP® ChFC AIF® In addition to many published articles and quotes in the financial press, Mr. Stanley regularly conducts continuing education classes for Attorneys and CPAs and is available for public speaking, seminars and private consultations. He is also a wealth manager with Capital Financial Advisors, LLC, a fee-only Wealth Management Firm in La Jolla, CA whose mission it is to provide Wealth Management to Successful Business Owners. Mr. Stanley can be reached at 858-395-8694 or cls@charlesstanley.cc or www.charlesstanley.cc