

# THE ONLY THREE QUESTIONS THAT COUNT

How can you discover something the crowd doesn't know? It's not so hard to find patterns that will give a bet-able advantage.

By Kenneth L. Fisher

**I**N INVESTING 101, THEY TEACH YOU THAT THE MARKET IS AN EFFICIENT DIS-counter of all widely known information. Therefore, the only way to beat the market—other than with blind luck—is knowing something others don't. But how? They don't teach you that.

Investing is largely taught and applied as a traditional craft. You learn an approved curriculum, apprentice under a master craftsman and practice, practice, practice until you're a master yourself. People undertake virtual apprenticeships and try to invest like Peter Lynch or Warren Buffet. Growth groupies do it one way, value vamps another. There are endless books that teach you all about the craft, from Ben Graham on, be it buying at low valuations or high momentums.

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**Yet, as** academics remind us, precious few beat the markets over the long term. Among those who have, there's no investing school that has created a preponderance of market beaters, not growth, value or small cap. Nor do legendary practitioners fall into any particular curriculum. All curricula dwell in the realm of widely known information, which is, by definition, factored into pricing. To beat the market over the long term, you must know something others don't. How do you do that?

### THE SCIENTIFIC METHOD

My third of a century in the industry and my long history of beating the market convince me that there is a way to know things others don't. It is basically the scientific method, which is rarely applied to markets. I detail it in my book, *The Only Three Questions That Count* (John Wiley & Sons), due out in January 2007.

I have learned, first, that much of what is widely believed about investing is mere myth. Second, investors don't seek out what others don't know because they assume it can't be done. How do you fathom the unfathomable? They are missing bet-able patterns because they

framework, we can see it clearly. If we receive the same information from another vantage point, we miss it altogether. By understanding how evolutionary psychology and behavioral finance overlap and by using scientific inquiry, we can turn our brains from our worst investing enemy into our friend. Or, as Homer Simpson would say, "Brain, I know you and I have never been friends, but . . ."

You don't need to be right all the time—just more often than you're wrong. To do that, start thinking like a scientist, creating a query session leading to actionable advantages over your peers. First, we need a question that helps us where we see wrongly. Then, we need one that helps us where we don't see at all. Third, we need a question helping us sense reality when our eyes aren't the right tools.

**Question 1: What do you believe that is actually wrong?** If most people believe X causes Y, but you can prove that X doesn't cause Y, you can bet against Y happening while everyone else bets it will happen. You have debunked a myth and can make one fewer mistake—and you can bet successfully against the crowd.

**Question 2: What can you fathom that others find unfathomable?** Most folks would say "nothing." But you

can do this. It's what made Edison and Einstein so successful but weird—they could figure out how to think about the unthinkable. You know that if no one knows what causes Q, and you can prove Z causes Q, then, when you see Z happen, you can bet on Q. You know something others don't.

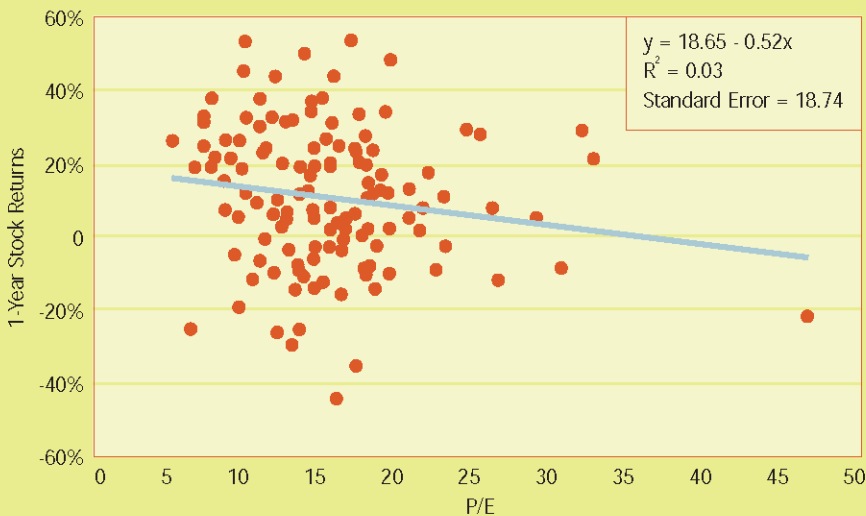
**Question 3: What is your brain doing to blindside you now?** This question links your brain to behavioral and evolutionary psychology. Learn how your brain hurts you, and you can retrain it. Most investors focus on craft, not an internal deficiency.

### FATHOM THE UNFATHOMABLE

How might you apply this process? Take a common myth: People believe that markets with high price-earnings ratios are risky and generate low returns.

## HIGH P/Es WON'T HURT YOU

As this chart shows, there is almost no correlation between high—or low—price-earnings ratios and subsequent market returns.



Source: Robert J. Shiller, Ibbotson Analyst, Global Financial Data, Standard & Poor's, Federal Reserve, Thomson Financial Datastream

don't know that they can look for them or how to do so.

Third, our brains weren't set up to do this stuff. Our distant ancestors were wired to deal with survival problems, not capital markets. If we receive information in a certain

The famous 1996 and 1998 Campbell-Shiller studies demonstrated it, and the 2000 to 2003 debacle proved it. Is any of this true? Whenever you run into anything "everyone knows," it's always time to apply Question 1: Do high

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p/e markets really have lower returns than low p/e markets? You can use simple statistics to prove scientifically that p/e ratios tell you nothing about market returns.

The studies showing that a high p/e market creates low returns have convoluted definitions of p/e or rely on a time period that forces the causal relationships. Take historical trailing simple p/e ratios and U.S. stock returns in the next one, two and three years, and you'll see that there is no predictive power to p/e ratios.

It's easy to do. You calculate a correlation coefficient, which can be done in 22 seconds by downloading market p/e ratios for each year and subsequent returns from the Internet into Excel, and tell Excel you want one. (If you can't use Excel for this, get a teenager to do it for you.) The correlation coefficient tells you the relationship between two sets of data. If two things are perfectly correlated (I zig; you zig), the correlation coefficient is 1.0. If they are perfectly negatively correlated (I zig; you zag), the coefficient is -1.0. And if they aren't correlated (I zig; you Cleveland), the coefficient is 0.0. Then you square the coefficient to get an R-squared, which tells you how much of the one may be caused by the other. When you do this with start-of-year p/e ratios and subsequent one-year stock returns, the R-squared is 0.03, meaning maybe 3% of stock price movement can be explained by p/e ratios. That's a myth you want to bet against.

In graphing p/e ratios versus U.S. stock returns since 1872 (we used Cowles data prior to the inception of the S&P 500)—don't let the slightly negative trend line fool you—the results look like a full-choke shotgun blast at 40 yards through a mild breeze (see "High P/Es Won't Hurt You," page 72). No relationship. One myth down.

Try two- or three-year returns, and you won't find enough relatedness to relate to. Anyone can do this and it takes about no time. Think of it another way: We noted the p/e at the start of each year and the subsequent annual return, and arrayed the years from low p/e on the left to

high p/e on the right. In the 17 highest p/e years (those with p/es over 20), only five years were negative, the market was up 70% of the time. Of the 117 lower p/e years, only 35 were negative and the market was up 70% of that time. No difference. You don't need fancy math for this.

You can play a mind game and believe it isn't that high p/es are bad, but that low p/es are good. Look at the 66 years the market started with a p/e below 14. There were

## THE MINUSES OF BUDGET SURPLUSES

Everyone assumes federal deficits are bad, but the numbers show that big deficits are followed by high market returns, and surpluses by weak returns.

Surplus Peaks					Subsequent S&P 500 Price Return			Deficit Troughs				Subsequent S&P 500 Price Return		
Date		12 mo.	24 mo.	36 mo.	Date		12 mo.	24 mo.	36 mo.	Date		12 mo.	24 mo.	36 mo.
Q3 1947	Annualized	2.6%	1.6%	8.8%	Q4 1949	Annualized	21.8%	19.1%	16.6%	Q4 1953	Annualized	45.0%	35.4%	23.4%
	Cumulative	2.6%	3.2%	28.8%		Cumulative	21.8%	41.8%	58.6%		Cumulative	45.0%	83.3%	88.1%
Q4 1950	Annualized	16.5%	14.1%	6.7%	Q4 1953	Annualized	45.0%	35.4%	23.4%	Q4 1953	Annualized	45.0%	35.4%	23.4%
	Cumulative	16.5%	30.2%	21.6%		Cumulative	45.0%	83.3%	88.1%		Cumulative	45.0%	83.3%	88.1%
Q4 1955	Annualized	26.4%	13.9%	3.6%	Q1 1958	Annualized	31.7%	14.7%	15.6%	Q1 1958	Annualized	31.7%	14.7%	15.6%
	Cumulative	26.4%	29.7%	11.1%		Cumulative	31.7%	31.4%	54.5%		Cumulative	31.7%	31.4%	54.5%
Q4 1959	Annualized	-3.0%	9.3%	1.8%	Q1 1967	Annualized	0.0%	6.1%	-0.2%	Q1 1967	Annualized	0.0%	6.1%	-0.2%
	Cumulative	-3.0%	19.5%	5.4%		Cumulative	0.0%	12.5%	-0.6%		Cumulative	0.0%	12.5%	-0.6%
Q4 1968	Annualized	-11.4%	-5.8%	-0.6%	Q1 1971	Annualized	6.9%	5.4%	-2.1%	Q1 1971	Annualized	6.9%	5.4%	-2.1%
	Cumulative	-11.4%	-11.3%	-1.7%		Cumulative	6.9%	11.2%	-6.3%		Cumulative	6.9%	11.2%	-6.3%
Q3 1973	Annualized	-41.4%	-12.1%	-1.0%	Q1 1975	Annualized	23.3%	8.7%	2.3%	Q1 1975	Annualized	23.3%	8.7%	2.3%
	Cumulative	-41.4%	-22.7%	-2.9%		Cumulative	23.3%	18.1%	7.0%		Cumulative	23.3%	18.1%	7.0%
Q1 1979	Annualized	0.5%	15.7%	3.3%	Q3 1982	Annualized	37.9%	17.4%	14.8%	Q3 1982	Annualized	37.9%	17.4%	14.8%
	Cumulative	0.5%	33.9%	10.2%		Cumulative	37.9%	37.9%	51.2%		Cumulative	37.9%	37.9%	51.2%
Q4 1988	Annualized	27.3%	9.0%	14.5%	Q2 1992	Annualized	10.4%	4.3%	10.1%	Q2 1992	Annualized	10.4%	4.3%	10.1%
	Cumulative	27.3%	18.9%	50.2%		Cumulative	10.4%	8.9%	33.5%		Cumulative	10.4%	8.9%	33.5%
Q4 1999	Annualized	-10.1%	-11.6%	-15.7%	Q2 2003	Annualized	19.1%	6.3%	26.6%	Q2 2003	Annualized	19.1%	6.3%	26.6%
	Cumulative	-10.1%	-21.9%	-40.1%		Cumulative	19.1%	8.6%	37.6%		Cumulative	19.1%	8.6%	37.6%
Average	Annualized	0.8%	3.8%	2.4%	Average	Annualized	21.8%	13.0%	11.9%	Average	Annualized	21.8%	13.0%	11.9%
Average	Cumulative	3.5%	8.8%	9.2%	Average	Cumulative	21.8%	28.2%	35.9	Average	Cumulative	21.8%	28.2%	35.9

Source: Global Financial Data

21 negative years and the market was up 68% of the time. Sounds like the same 70% to me.

This is not a matter of fancy statistics. You just need patience to organize the numbers. That's what I did with my friend Meir Statman, the Glen Klimek professor of finance at the Leavy School of Business at Santa Clara University, in "Market Timing at Home and Abroad," published in the *Journal of Investing*, Summer 2006.

Suppose you think it isn't just high and low p/e ratios, but some magic levels, like sell when the p/e gets to 22 and buy when it hits 15. You can test that too. Just count the

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number of times it has happened. Statman and I did that for every possible buy-and-sell combination and found only one that beat a simple buy and hold. Is that one the Holy Grail? Test it overseas to see. We ran the p/e-return numbers for the major overseas markets and demonstrated that it wasn't. Anytime you find something you think works in the U.S., test it overseas in other developed Western countries because if it doesn't work there, then it's just a fluke here. Global testing is key in your quest to prove and disprove.

### FEAR OF FALLING

Why do we think p/e ratios affect returns? The answer comes from behavioral psychology (confirmation bias) and evolutionary psychology (fear of heights). Your brain is hard-wired to react with fear when information comes to you in a heights format. Our Stone Age ancestors survived because they had a healthy fear of heights—the higher, the worse! Today when folks are confronted with a heights framework, even for p/e ratios, that fear gets activated. People envision higher p/e ratios as further potential falls and lower p/e ratios as less distance to smack into the floor, hence less risk.

Confirmation bias is the tendency to see things that confirm our prior beliefs, but to not see evidence that contra-

blindsides me now? Well, we know fear of heights and confirmation bias are kicking in.

So reframe the heights belief. Turn the p/e into an e/p and compare with long-term corporate interest rates. This is the right way to think about the value proposition: A price-earnings ratio of 10 is an e/p or after-tax earnings yield of 10%, which beats the heck out of a 6% pretax 10-year corporate bond. Any such firm can borrow money at the 6% pretax rate (a 4% after-tax cost of money), buy back its own stock and drive up its e/p. When the firm does this, it picks up the 10% (earnings yield) minus 4% (aftertax cost of money) to equal the 6% spread as free money. Suddenly you're fathoming something most folks don't—a Question 2, and one you can bet on regularly. Managements with e/p's that are well above long-term borrowing costs are either going to get their stock up—or someone hostile will do it for them. That's a bet-able event.

### BET ON BIG DEBT

Question 1 often debunks a myth. But sometimes a myth is so wrong the reverse ends up being right. Everyone thinks X causes Y, but in reality, X causes -Y. Demonstrate that, and you've disproved a myth and fathomed the unfathomable.

For example, everyone believes debt is bad and more debt is worse, and the U.S.—particularly the government—is markedly over-indebted. Hence everyone knows big federal budget deficits cause more total debt, which must be paid back and drags down stock prices in the long term. But what “everyone knows” is a Question 1 to verify. In this case it leads to a Question 2: Could big federal budget deficits be good for stocks?

Ask that question too loudly and someone may commit you to a padded cell. Debt being bad is part of our collective Western-world wisdom. We, like our Puritan forefathers,

are morally opposed to debt. Other Western developed nations also fret over deficits. In fact, they fret over our debt—often more than their own. Is any of this deserved? If there is no empirical evidence supporting the hypothesis, could the opposite be true? Question 2!

It appears the opposite is true. We mapped the federal budget balance since 1947 as a percent of annual GDP and noted the surplus peaks and deficit troughs. Look at the returns in the year after these surpluses and deficits (see

## CORRECTING COGNITIVE ERRORS

Academic studies have identified numerous irrational financial behaviors that blind investors to market realities. Here are a few.

- > **CONFIRMATION BIAS:** Seeking evidence confirming investors' preset notions while rejecting contrary evidence.
- > **ILLUSION OF VALIDITY:** Believing in false myths.
- > **OVERCONFIDENCE:** Overestimating an investor's own skill or knowledge.
- > **LOSS AVERSION:** Acting to avoid short-term losses and giving up longer-term gains because investors dislike losses more than they like gains.
- > **ORDER PREFERENCE:** Insisting on things in a certain order based solely on social convention. For example, making annual forecasts in January instead of April.

dicts them. Behavioralists have proved we do this. We don't see the high p/e years that did well and the low p/e years that did badly. Fear of heights makes our myth feel right. Confirmation bias causes us to ignore contradictory evidence.

What can you do with this knowledge? First, when you see that the masses are afraid of a high p/e market, you can bet against them. Fear in the market of something non-causal is always bullish because eventually it will be relieved. Then ask Question 3: What is my brain doing to

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"The Minuses of Budget Surpluses," page 73). Compare the 12-month returns after budget surpluses with the returns after deficits. The counterintuitive truth is that stock market returns have done better after big deficits than after surpluses—by a lot. No fancy math needed.

Which do you want? The consistently high returns averaging 22% or those averaging 0.8%? Now look out 36 months. Those appalling deficits get you an average cumulative return of 36%, versus 9.2% from surpluses. While trading p/es doesn't beat the market, trading deficit/surplus extremes does—significantly. Buying after budget surpluses would have rendered materially below-average returns. Knowing this would have helped you time the 2000 market peak and the 2003 bottom. That is something you can know that others will simply reject.

This may not make sense at first. It flies in the face of conventional wisdom (which is good). That budget deficits are good for stocks isn't a fluke. From an economics standpoint, it makes sense if you can fathom one unfathomable fact—that the U.S. isn't over-indebted as everyone believes. In fact, it's provably very under-indebted. The U.S. needs about three times as much of all forms of debt as it has now to have the right amount of debt.

I bet you've never asked what the right amount of debt is for a society. You presume less is better. But that can't be right or we wouldn't have corporate debt. So what is the right amount of debt? I can't explain here (although I do in my book), but pretend you accept that we're under-indebted. Suddenly you find the market acting quite rationally when deficits lead to good markets and surpluses to bad. After all, if we're under-indebted, then surpluses reduce debt and move us away from an optimal amount of debt. It's true, but religiously unfathomable to most people. And religiously held myths are great when you can bet against them. Recall that if an unfathomable is true here, it must also be true in other Western markets to show that it isn't a fluke. In my book I lay out the numbers for Britain, Germany and Japan and you see the same pattern. Unfathomable!

### SCALE IT TO SEE IT

Not questioning your beliefs is a sign of overconfidence—a cognitive error you can learn to combat with Question 3. You need an open mind to be a scientist. When you ask Question 3—how is my brain blindsiding me?—you'll get a

variety of answers. Cognitive bias, confirmation bias, illusion of validity, overconfidence, loss aversion, order preference and more. Once you learn to recognize these errors and catch yourself committing one, you can counteract it. One tool for combating a slew of cognitive errors is simple scaling. By looking at the deficit as a percent of GDP, we used scaling to provide a sense of proportion and relative-ness, which is what the market cares about.

Our Stone Age ancestors knew a bunny was small and an elephant was big. But they couldn't tell if a truck was bigger than an elephant. There were too many ways to measure that. Mass? Speed? Trunk space? Our brains can't fathom differences unless we have an appropriate scale.

Big numbers can be scary, like a stampeding elephant. Learning to scale helps us see relative size correctly whether it applies to debt, deficit, GDP or jobs. Take the tragedy of Katrina. Should it have scared you

economically? Scale it to see. Before Katrina, Louisiana's GDP was 0.9% of America's GDP. If every job in Louisiana were lost, the U.S. GDP would fall by 1%. If GDP would otherwise grow by 4%, GDP growth would decrease by one-fourth. But America is only 38% of the world's GDP. Hence Katrina could only cost global GDP, which is what really matters, one-third of 1%—a tiny blip. Therefore, when Katrina hit, the market didn't fall and U.S.

and global GDP moved along unabated. The market acted rationally. Scaling is also great because it regularly helps you relieve client fears.

There is no end to the myths you can debunk and unfathomable truths you can discover with the Three Questions. Does oil impact stock prices? Does gold predict inflation? Is there anything that has a very high correlation to value/growth cycles? These are bet-able truths you can find. The more you ask, the more you learn, and the more you use these Questions, the more you know something others don't. That way you'll have a basis for making bets consistent with finance theory, and a basis for beating markets. What counts more?

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**THERE IS NO END TO THE MYTHS YOU CAN DEBUNK WITH THE THREE QUESTIONS. THE MORE YOU ASK, THE MORE YOU KNOW SOMETHING OTHERS DON'T.**

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