BY KENNETH L. FISHER

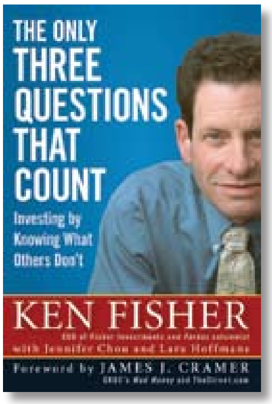
The Science of Investing

Legendary investor Ken Fisher's new book shows how investors can get an edge by exploring three simple questions.

FINANCE THEORY SAYS: THE ONLY WAY TO BEAT THE market is by knowing what others don't. Few fight me on that. But in today's über-connected world, how can anyone know what thousands of others, equally as plugged-, blogged-, and tuned-in, don't?

Unique market-beating information can be yours, as I detail in my new book, *The Only Three Questions That Count* (John Wiley & Sons). In it, I demonstrate how beating the market is possible if you stop treating investing as a craft, and start approaching it as a science.

Why shouldn't investing be a science? Investing is far more comparable to medicine, in a sense, than accounting. Accounting is a craft. So is blacksmithing. In both, practitioners study, apprentice, get their journeyman's card, and off they go to become master craftsmen. Sure, things change. New methods are introduced. Dingbat politicians write new laws. But new discoveries about fungus don't radically alter the face of accounting. If investing were a craft, some craft-like method would have demonstrated superiority, and we'd all be banging away with the same, market-beating hammer. No, investing is a non-stop, scientific discovery.



And all scientists require a scientific method — a targeted query session. But for answers providing the basis for actionable market bets, you need the right questions.

What are the right questions? First: What do you believe that's false? This question prevents mistakes made by betting on widely believed but baseless myths. And it gives you the basis for a bet. If what everyone expects to happen probably won't, you can bet against them and win.

Second: What can you fathom that others can't? This helps you see what others can't or won't, giving you yet another basis for market-beating bets. And it's easy to do. In my book I show you how.

Finally: What is your brain doing to blindside you? This counteracts your worst enemy — your modern skull containing a Stone Age brain, well-equipped to keep you warm, dry, and relatively free from saber-tooth puncture wounds, but miserable at dealing with counter-intuitive, intangible capital markets.

The questions help you see the truth about common investing concerns. For example, most people believe high P/E stocks are risky and debt is deadly for our economy. For a moment, pretend you could prove these concerns wrong. Fear of a false myth is bullish. If everyone is exercised over something you know won't have the outcome everyone expects, you can bet against them and win. The truth is, high P/Es, debt, and deficits, to name just a few concerns tackled in my book, don't work the way people think. With the questions you'll find commonly accepted wisdom about these and many other concerns to be nothing more than mythology.

To demonstrate the questions, consider our trade deficit. Most agree a trade deficit perpetuates economic weakness. You certainly don't hear anyone saying, "Trade deficits are great!" In 2006, journalists derived Schadenfreude by reporting impending economic devastation at the hands of our burgeoning trade deficit. The weakening dollar was deemed the smoking gun of the trade deficit's negative repercussions.

The trade deficit isn't likely to shrink dramatically in 2007, and a broad consensus agrees this is more bad news for the dollar. Before you don your tinfoil hat, ask question one. Is it true a trade deficit causes a weak dollar?

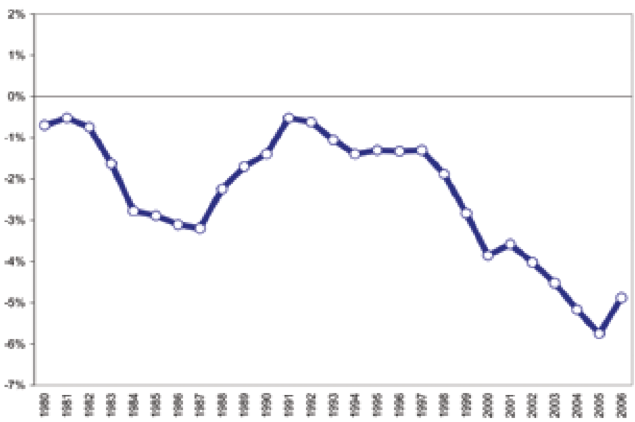
How would you even check?

Why not see if similarly sized deficits in other nations caused similarly weak currencies?

You may scoff, "No one else has a trade deficit that size!" Not so! The Brits are an excellent litmus test for many American economic conditions. They have a well-diversified economy and stock market mirroring the relative size and composition of America's.

The American trade deficit as a percent of GDP has been increasing irregularly since 1980 and now stands at about 4.9 percent (as of third quarter, 2006) — near record size! And the U.S. dollar was weak in 2004 and 2006. Never mind the dollar strengthened in all of 2005 — maybe that was a fluke. Check Britain and see.

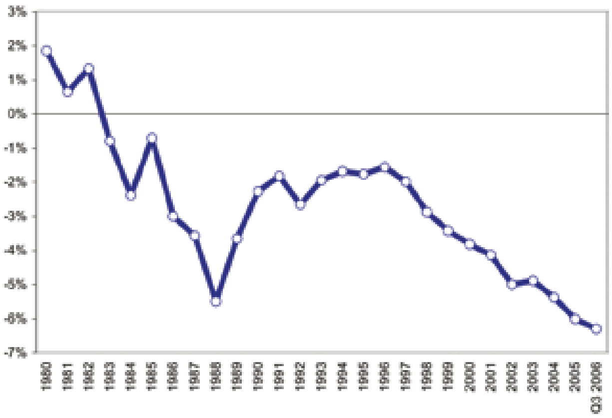
American Trade Deficit As A Percent Of GDP



The Brits experienced a similar trajectory and their deficit is now 6.3 percent. Higher than ours! Yet, the pound sterling was very strong, not just recently, but consistently in recent decades. What gives?

Maybe the cumulative effect matters most. After all, we've had a huge deficit seemingly forever, and that's weakening the dollar. Fine. Take the cumulative U.S. trade deficit since 1980 and divide by today's GDP; do the same for the Brits, and you get 42 percent and 46 percent, respectively. Not too different.

British Trade Deficit As A Percent Of GDP



To argue our trade deficit weakens the dollar, you must also argue the similarly sized U.K. trade deficit is somehow good for the pound. That's a pretty silly argument. Your answer to this question is: No, the trade deficit has zero impact on the dollar. (In the book, we discuss whether a weak dollar even matters — it doesn't — and what really drives a currency's relative strength.)

Maybe the dollar gets a pass, but the trade deficit must be bad for the economy and stocks. Importing more than we export must be unsustainable. Freed from the weak-dollar myth, use question two. What you can fathom about the trade deficit?

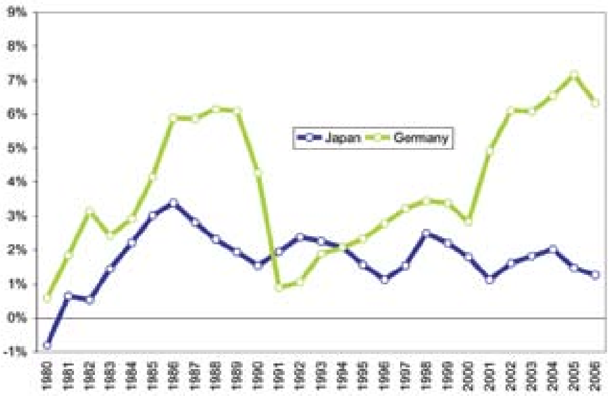
Think about it a new way. Apple iPod components are manufactured cheaply overseas (Egads! Outsourcing!), creating a trade deficit. But Apple sells its many iPod creations at a hefty profit margin, increasing earnings-per-share. Intentionally creating a trade deficit is smart management by Apple. It increases shareholder wealth and makes the product more competitive. And Apple is not the only one doing it!

Is it possible a trade deficit is not a harbinger of economic doom? Rather, it's symptomatic of a healthy economy? That's pretty unfathomable.

In the graph, you can see those clever Germans and

Japanese have run trade surpluses while the U.S. and U.K. have run big and growing trade deficits. But which economy would you rather have? Both the U.S. and U.K. have had robust GDP growth and above-average annualized market returns since 1990, while Germany and Japan have had sluggish growth and below-average returns. Their trade surpluses haven't helped them. In fact, the data show the reverse of the myth might be true — that deficits are healthy and surpluses undesirable. How could that be?

Japanese and German Trade Balance As Percent Of GDP



Both Germany and Japan have governmentally imposed economic throttles aimed at artificially creating trade surpluses, under the belief that surpluses help their economies. Not so — this mercantilist experiment hasn't worked in their favor. Increased governmental meddling inhibits the wild will of capitalism and dampens growth. The U.S. and U.K., having deeper faith in capitalism, have avoided such silliness and been well-rewarded. Fathom that: Trade deficits, in developed nations, are a great good thing.

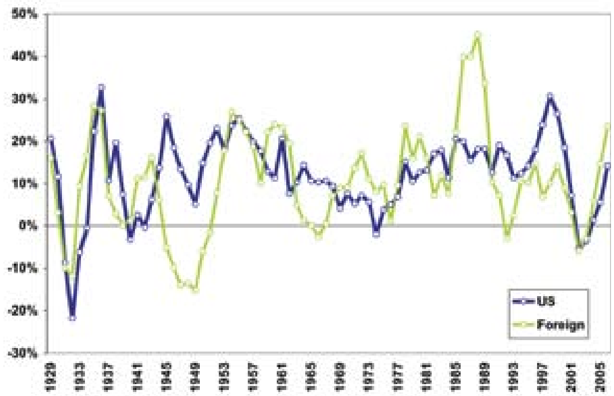
We're not done yet. Always, when confronted with any investing dilemma, ask what your brain is doing to muck you up? In my book, I detail some common cognitive biases causing investors to have a distorted view the world — myopic loss aversion, confirmation bias, order preference and more. A cognitive bias is when your brain distorts reality to fit some comfortable notion. It's not your fault. Studies in behavioral finance show this is more a result of how the human brain evolved than any personal failing.

A major way your brain misleads you on trade deficits is investors tend to provinciality. Cavemen thought about their tribe and didn't care much about their neighbors, unless under attack. Today, Americans think America matters, and we pay less heed to economic heathens outside our gate. But why? By examining the U.K., we see our silly deficit prejudice is unwarranted. And the Brits are practically American! We don't share a common language, but we share a similar disdain for the French.

By adopting global thinking, you realize trade deficits don't matter. Globally, there is no trade deficit — it all balances. You don't fret if Montana has a trade deficit with New York, so why break into hives when the U.S. has a trade deficit with China?

Some may argue most Americans don't invest globally. They fixate on the S&P 500. Even if you reject global investing, against my recommendation, you must still think globally. Developed economies are far more correlated than you realize. If we have a trade deficit, and that's bad, and other nations have a surplus, and that's good, shouldn't our stock returns be all over the map?

U.S. vs. Foreign Markets



In any given year, U.S. and foreign markets tend to move in the same direction, as shown in the graph. It's very rare for the U.S. market to be down big when the foreign market is positive. If our big deficit mattered, we should see much more differentiation in market returns.

If you can get global thinking in your bones, many other misplaced investor concerns fall away. You needn't worry about U.S. inflation, since it's the global supply of money that matters. You know U.S. GDP doesn't matter much; you must look at global GDP growth since America is only 38 percent of global GDP. If you do that, you'll definitely know what others don't, since most investors' vision blurs at the shoreline.

Even with global goggles, some folks still fret. Deficits just feel wrong — the word shares a Latin root with "deficient," and that must be bad. How else are our brains betraying us here? You hear frequently that Americans' profligacy causes the trade deficit (among other problems). Shame on me, and you too! This is evidenced in our personal saving rate which garnered much press by recently turning negative. Egads! We're unsaving!

This is the *illusion of validity*, another cognitive bias, at work. Isn't it common sense that Americans are all crass profligates? And there's data to back it up! The saving rate proves it. Our brains love an "expert" or data confirming what we already believe. And while disproving one myth, you find another to tackle with the three questions.

My book fully details why the personal saving rate doesn't matter (in fact, a negative rate is probably a good sign), but governmentally produced data should always be viewed with extreme cynicism.

Using the questions, you discover in 2005 that the U.S. government deducted nearly $1 trillion from the saving accounting. What was this massive line item? The amount of rent Uncle Sam thinks homeowners ought to pay themselves for living in the homes they own and occupy. Insanity! I own a home, and I don't pay rent to myself. (Maybe you do because you're crazy.)

In my view, I'm actually saving myself rent money. Sure, some folks pay a mortgage (which government accountants consider an expense, while dinging you a second time for fake rent), but they're paying interest on an appreciating asset, not paying rent.

Even crazier, did you know Bill Gates, the world's richest man, never saved anything? The government says he didn't! (The government says I never saved either, yet *Forbes* was crazy enough to put me on their list of richest Americans.) He started Microsoft which became incredibly valuable, but he never saved. I started my firm. Maybe you started a firm, too.

Today Americans primarily save through capital gains in one form or another. Americans increase their wealth in diverse ways, but the government doesn't know how to calculate that. Unrealized capital gains aren't included in "savings," while journalists scold us for being profligate. And we believe our naughtiness contributes to a trade deficit, which upon deeper analysis isn't something to fret about either.

The good news in all this is most folks will continue to worry about a trade deficit wreaking havoc. But, because what they expect to happen probably won't, and you know that, you can bet against them and win. Put that to use in your portfolio this year, because trade deficit bears are still pounding their drums. Ⓡ

Kenneth L. Fisher is founder and CEO of Fisher Investments, an independent, global money management firm. He has been writing in Forbes since 1984. His new book, *The Only Three Questions That Count*, is just out from John Wiley & Sons.