

## COB Review by Austin Spencer

Title: "The Four Pillars of Investing: Lessons for Building a Winning Portfolio"

Author: William J. Bernstein PhD. M.D.

Length: 297 pages

Reading time: 10 hours

Reading rating 4 (1 = very difficult; 10 = very easy)

Overall rating: 4 (1 = average, 4 = outstanding)

The fourteen plus chapters in Bernstein's book, "The Four Pillars of Investing," are concerned with a review of basic truths of equity investing. The opening discussion considers a basic proposition in finance: there is always a risk return trade-off in investing in securities. History has repeatedly confirmed this trade-off. Anyone that ignores it will be brutally disciplined by the financial markets.

The author suggests that the best way to gain wisdom about the markets is not reading alternative investment strategies but rather to immerse oneself in the history of investing. This excursion will instill in the investor the sobering truths about investing in securities. The author provides an excellent digest of this literature which should quickly mature the new or inexperienced investor. Issues related to investor psychology are covered in an interesting but less than comprehensive discussion.

The major theme in the second section of the book is a basic truth about the equity markets which every investor should remember. Equity markets are prone to fits of irrationality which ignite the investor's greed instinct and inevitably destroy a significant amount of investor wealth.

In the third section of the book, the author takes on the attitude of a parent. Principle one: the investor, whether an individual or a mutual fund, will not identify outperforming stocks over the long run. Performance will inevitably revert to mean performance or worse in the case of actively managed mutual funds where fees and expenses eat up any excess gains. The sobering truth is the investor should invest with a long run perspective and be content with the returns available in index funds. Bernstein is very critical of stockbrokers who he views as super sales people but poor financial guides to wealth creation.

Principle two: the primary area where there are gains available is asset allocation. The author suggests that investors needlessly sacrifice performance over time by being inadequately diversified. Alternative asset allocation strategies are suggested for investors depending on their risk tolerance.

There are several additional ideas I would add to the excellent discussion provided by the author. First, the investor should organize indexes by stock capitalization (the number of shares outstanding times the market price per share): large cap, mid cap, and small cap. Within each stock capitalization category, funds should be grouped by the index they

follow. What is the importance of listing index funds by capitalization? Capitalization size highlights the potential for a stock index to provide diversification to your portfolio. Every index is diversified in the sense that no individual stock holding will have a significant impact. However, from a different perspective the impact that any given fund will have on your portfolio will differ. The different cap size indexes represent different industry weightings and stock at differing points in their lifecycle. In order for your own portfolio to be diversified, you must gain exposure to all these varied stock groups. To do this you will have to purchase large, mid and small cap index funds at a minimum.

Austin Spencer is a professor of finance in the College of Business at Western Carolina University. His research interests include topics related to financial institutions and financial markets. For previous reviewed books, visit our Web site at [www.wcu.edu/cob/](http://www.wcu.edu/cob/).