Rational Expectations – A Review

It is no secret that I think highly of William Bernstein, MD and his writings. At my first Bogleheads convention (2008) Jack Bogle was in the hospital but I was only slightly disappointed because I got to meet Bill there, who had far more direct impact on my financial life than Jack did. His now 13 year old tome, The 4 Pillars of Investing, was easily the best of the first 20 financial books I ever read. Bill was also gracious enough to write the first guest post on this site and the foreword in my own The White Coat Investor: A Doctor’s Guide to Personal Finance and Investing. I’m embarrassed to say it took me far longer to get to his book than it took for him to get to mine.

The book I’ll be reviewing today is entitled Rational Expectations: Asset Allocation for Investing Adults. It is the fourth in Bernstein’s “Investing for Adults” series. I recommend all of them, however, none of them should be anywhere near the first investing book you read. As Bill says:

If the terms “standard deviation,” “correlation,” and “geometric average” are Greek to you, or if you think you can time the market or pick stocks, then don’t buy this book. And if you already have bought it, return it, or at least give it to someone who might make better use of it. The most commonly
used phrase in this book is “since you’re an investing adult.” What usually follows that phrase is brief reference to the knowledge base I assume you already have. If you’re looking for detailed data on the inability of active managers to add value, or descriptions of the mendacity of the investment industry, or basic financial history, once again, you’ll have to look elsewhere.

That “elsewhere” can most readily be found in two of Dr. Bernstein’s other books. First, the more recently published and simplified update of The Four Pillars book, entitled The Investor’s Manifesto. Second, in his shorter, more recent book that is perfect for young investors, entitled If You Can.

Rational Expectations does borrow heavily from other books Bill has written, but there is enough new stuff in there to keep even old hands interested. Plus, he’s a darn good finance writer. If I can read a few chapters of this book starting at 7 am after a night shift in a completely darkened room without falling asleep, that’s some real talent. The book is also highly “up-to-date” with many references to our current market environment and how to deal with it. If he hasn’t updated the book by 2020, it may very well be somewhat out of date by then.

Asset Class Models, Asset Classes for Real

The first quarter of the book is heavy on the theory and the math. I warn you now, there are equations printed in the book, not all of which I know how to derive. There is little you can directly take out of this section and apply to your investments, other than the idea that future returns of your investments are highly likely to be lower than the past returns. However, this section lays a necessary foundation for the much more practical remainder of the book.

My Favorite Chart
My favorite chart in the book was Figure 1-3, where he plots the Percent Market Decline on the X axis and the Percent of Investors Who Abandon Their Strategy on the Y Axis. At a 50% drop, such as the 2008-2009 Global Financial Crisis, about 70% of investors abandoned their strategy. At a 90% drop, such as in the Great Depression, that number approaches 100%. While I don’t think this chart is actually generated from any true empirical data, the concept behind it is not only accurate, but extremely important when determining your asset allocation.

Diversify Me! Portfolio Models: Simple and Not So Simple

The second section takes an investor through basic portfolio assembly- your stock/bond mix, what stock asset classes to consider including, how much tilt and what kinds of tilts to consider, and how to add bonds to the portfolio. He introduces the factors of small, value, profitability, and momentum. Perhaps the most interesting part of this chapter was the discussion of why using CAPE (Cyclically Adjusted Price to Earnings ratio) to determine your asset allocation is not particularly useful, especially the discussion of the “new tail” that showed up after 1995. That was the first time that a high CAPE did not result in future poor returns. This concept of “nonstationaryness” is worth the price of admission.
to the book. (If that paragraph just scared you off from this book, go buy *If You Can: How Millennials Can Get Rich Slowly* instead.)

**The Evil Nexus: Market History, Your Portfolio, and Your Brain**

The third chapter in the book is all about behavioral economics. The basic idea here is to be as Aspergian as possible with your investments. Rational beats emotional approximately 99% of the time. “Such imperviousness to the emotions of others is immensely valuable in finance.” The section about how we all overestimate our risk tolerance and underestimate uncertainty were exceptional as were the journal entries from the Great Depression.

**When to Hold ‘Em, When to Fold ‘Em: A Lifetime Asset-Allocation Trajectory**

This chapter introduces the concept of a Liability Matching Portfolio (LMP). This is basically a sum of money that can pay for all your necessary living expenses for the rest of your life while taking minimal risk. We’re talking a SPIA or a TIPS ladder here. Bernstein is famous for his idea that when you’ve won the game, you should quit playing it. Your Risk Portfolio (RP), any amount above and beyond the LMP is for special treats, inheritances, and charitable contributions. One of the best quotes from the book comes out of this section:

*If you learn nothing else from this book, remember this: the purpose of your investment plan is to accumulate an LMP tailored to your retirement needs. Your LMP, once achieved, should be sacred and should never, ever take a back seat to your desire for higher returns. The purpose of investing is not to simply optimize returns and make yourself rich. The purpose is to not die poor.*

I enjoyed the discussion of how you have to have a lot of time
and an incredible savings rate in order to invest in nothing but safe assets. I’ve written a similar post here. The best part of this section, however, was the discussion of how exactly to transition your portfolio from a standard accumulation portfolio to an LMP + RP. I loved his recommendation that while you invest the LMP very conservatively, you invest the RP as aggressively as you can tolerate.

Loose Ends

My favorite section of the book includes a discussion of the Flash Crash of 2010, which ought to scare you at least a little. It also includes the best discussion of duration I’ve yet seen. Bernstein says this about human capital and investment risk:

> It makes little sense to discuss the riskiness of stocks without specifying the ratio of human capital to investment capital. The lower that ratio is, the higher the risk. All investors should avoid nonsystematic risk—that is, the risk of not being properly diversified. But, to the extent that they can stomach it, younger savers, at least, should embrace as much systematic market risk as they can.

This chapter also discusses how you shouldn’t be too mad that interest rates have been so low these last few years. While it did cost 14% more to retire in 2013 than it did in 2008, the Fed’s accommodative policy has swollen your investments by far more than 14%. The remainder of this section rehashes the discussion of deep and shallow risk from book 3 in this series. The new part is the discussion of when shallow risk becomes as important or even more important than deep risk.

Walking The Walk: Nuts and Bolts for Investing Adults

This final section is the practical part. He discusses various asset allocations, recommends funds for each asset class
(hint: they’re almost all from DFA or Vanguard), and talks about the various ways to tilt a portfolio. He also discusses the various ways to rebalance. I found the discussion about why you shouldn’t use bond ETFs and his oft-repeated stance about not using bond funds in general particularly interesting, enough that I’ll be doing a future post about them.

Some (very mild) Criticism

I felt Bernstein’s discussion of Asset Location missed the boat. He focused too much on the tax-efficiency of assets and not enough on the expected return of those assets. He also buys into the “stocks in Roth” argument, dismissing the extremely valid even if impractical method of tax-adjusting your asset allocation out of hand without any real argument. While both of these are admittedly fairly minor points in portfolio construction, the book would have been stronger if he had dealt with both of them more in depth, as I have here and here. I also disagree with the “no bond funds” and “take no risk with fixed income” stances familiar to past readers of Bernstein books.

My Favorite Quotes

A few more quotes to give you a sense of just how many gems there are in this book:

*Investing is a game won by the most disciplined, not the smartest.*

*I hope by now I’ve convinced you there are no free volatility reducing lunches that will inexpensively reduce your portfolio risk, and there is no risk fairy to insure the risky parts of your portfolio on the cheap. Yes, there are people who—and vehicles that—will do this for you, but they will cost you a pretty penny.*
If you began your investing journey after 2009 or haven’t yet started, then you’re an investing virgin. It’s safest to assume that your true capacity is low, and you should start with a conservative stock bond allocation...if you find that you have a lower risk tolerance than you thought, at least you’ll discover it relatively early and with a relatively small portfolio.

The bottom line is that you should read a book by Dr. Bernstein. If you think you’re ready, read Rational Expectations. If you’re not, purchase The Investor’s Manifesto or If You Can first.

What do you think? Have you read the book? Did you change your asset allocation based on it? What was your favorite part? Comment below!