There is actually only one question that counts for investors who want to beat the market says money manager maestro and Forbes magazine columnist Ken Fisher. That single question is: What do you know that others don’t? Hence the subtitle of the book. The three questions that flow from it and reflect the book’s main title are:

1. What do you believe that is actually false? Answering this helps sweep away myths that erroneously influence investor behavior.

2. What can you fathom that others find unfathomable? This enables investors to spot trends and performance correlations that others miss.

3. What the heck is my brain doing to blindside me? This explains how instinctive behavior and the primitive “wiring” of our brains can lead to poor decision making.

The author is founder, chairman and CEO of Fisher Investments, an independent global money management firm with over $30 billion in assets. He is also one of the longest running columnists at Forbes magazine. His co-authors, Chou and Hoffmans, were respectively a capital market researcher and an investment counselor in his company.

Fisher admits to being regarded as something of a maverick in the investment community, but how others view him is none of his business, he says, pointing out nonetheless that he is a “self-made richie” on the Forbes 400 list of richest Americans, with personal wealth in excess of $1 billion.

A key element of his success has been a devotion to the questions that form the kernel of this book, but they do not represent an investing-made-easy “to do” list, he warns. Investors must know what the questions really mean and how to use them, then put them to use diligently, over and over again.

“If you can learn how to use the three questions you will have a lifelong basis of beating markets,” he suggests.
Myths and Conditioning

What we believe about stock market performance and the things that influence it are probably believed by most people. This is because, individually, we rarely investigate our beliefs, especially if intuitively, they seem to make sense and even more so if others seem to be in agreement with them. We are conditioned to accept, without question, wisdom passed on by others.

Medicine is a good example of this. We see a doctor, describe our symptoms, hear the diagnosis and accept the prescription. This conditioning serves us well and because there are so many life examples where it does, we are blind to the few areas like capital markets where it doesn’t.

We share many beliefs with other investors that simply are not true. They are built into decades of literature and are among the first things people learn when they start investing. We must use Question One to identify them: What do you believe that is actually false?

The author’s prime example is the significance of price-to-earnings (P/E) ratios - price per share divided by earnings per share. Investors categorically believe that when the stock market has a high P/E it is riskier and has less upside than when it has a low P/E.

Thinking about it casually, this seems to make sense; a high P/E means a stock or the whole market is priced high compared with earnings. Too high and we believe the stock or market must be overpriced and will start falling. The belief is so widely held by so many people and seems so logical that it has become a basic tenet of investing.

Yet Fisher says he proved statistically more than 10 years ago that P/E by itself, no matter its level, tells you nothing about market risk or return. So, when people are freaking out, fretting over the market P/E being too high, investors in the know can bet against the market falling. In the same way, if the market P/E is low and we can sense that people are optimistic because of it, we can bet against this.

Many false ideas like interpreting the P/E are accepted widely by the best and brightest minds and passed to the investing public through the media. Because there is no dissenting opinion, society feels no need to see proof of these alleged truisms with statistically valid data.

In addition to the P/E factor, the author offers a dozen more general beliefs most people hold that he says are partly or wholly false:

- Big government budget deficits are bad
- A weak US dollar is bad for stocks
- Rising interest rates are bad for stocks (and falling rates are good)
The Only Three Questions That Count

- A tax cut causes more debt, which is bad for stocks
- Higher oil prices are bad for stocks and the economy
- Stocks do well when the economy does well
- Stock markets do better in countries with faster growing economies
- Small stocks do better than big ones
- Stocks of firms that grow more do better than those that don’t
- Cheaper stocks do better than less-cheap stocks
- Current account and trade deficits are bad for the stock market
- America has way too much debt

These are merely a subset of a larger group of mistakenly held beliefs that prompt investors to misjudge stock market behavior. To change your investing success levels, you must learn to be skeptical, says the author. Look around and assess what you and your fellow investors are accepting as fact. Practice using Question One by scanning the media for assertions you believe, about single stocks, currencies or whole markets. Then put them to the test.

Ask yourself what would make you buy or sell a particular stock, making a list of the influences and a note of any decisions not supported by data or other information. Be particularly wary of making a decision because of something you know and with which others agree.

Searching Beyond the Noise

The media is a discounting machine. Everything they say is priced into a stock before you buy it. For example, there was the turn of the century Y2K scare which, it was claimed, would negatively impact stock prices in the new millennium, however its potential effects had already been built into stock prices, enabling those who recognized this to bet against a fall at the start of 2000.

That doesn’t mean you should ignore the media. You must read, watch and listen to know what everyone else is focused on - “the noise” - so you know what you can ignore and look away from. Your task then is to search elsewhere, to answer Question Two: What can you fathom that others find unfathomable?

The author recalls one of his Forbes columns that lists four steps you can take, whenever you are presented with an investment decision, to help you ignore the noise:

1. If most folks you know agree with you on a likely price move, this is a warning that you’re wrong. Being right requires loneliness.
2. If you read or hear about an investment idea or significant event more than once in the media, it won't work.

3. The older an argument is, the less power it has. Every year's hot fear is obsolete by next year.

4. Any category of security that was hot in the last five years won't be in the next five.

By asking Question Two, you look away from the noise for one of two things: First, you need to identify a correlation between two or more variables that others think are unrelated. Second, you discern a pattern that others can see but which they disregard, deride or misinterpret.

An example of such a pattern comes from examining the short-to-long term yield curve of interest rates.

The curve indicates the level of interest rates over various borrowing terms and usually slopes upward to the right, indicating higher rates in return for the risk associated with longer periods. Sometimes, however, there is little difference over time and the graph is flat, or, rarely, the curve is even inverted.

An inverted yield is said to indicate a bear market but, says Fisher, that depends. To use Question Two, you must ask if there is a graph that is more important to market direction than that of the US and the answer, for this purpose, is the global yield curve which reflects worldwide lending conditions and is now more relevant as a measure of sentiment.

Sometimes, the US yield curve may be negative but this, by itself, is no cause for panic. But when the global yield curve inverts, as it did in 1989, it signaled an oncoming recession. The global curve, the author concludes, is a more useful leading indicator of stocks and the global economy than any single country’s curve.

Knowing this, an investor can avoid making an incorrect reading if, for example, the US curve is negative but the global curve remains positive.

The author goes on to show how the gap or spread between short term and longer term interest rates varies over time and how this might be used to identify another market trend that others have not yet recognized. He reveals that after a yield curve steepens significantly, value stocks are seen to outperform growth stocks. After the curve flattens, growth takes over leadership from value. In other words, the global yield curve tells you when to switch from value to growth and vice versa.

**Two Important Riders on Question Two:**

First, when trying to identify market factors that others do not know, you must be sure that the relationship you have spotted is causal. It may be nothing more than a coincidence so you must search for the evidence that underlies its effects. With the yield curve spread, for instance, there is an absolute explanation of how the switch
between growth and value stocks occurs, stemming from how corporations raise capital and how much incentive banks have to lend that capital.

Second, your Question Two discoveries have a finite life - a period of usefulness before others identify the same correlations and they become priced into the market. The author’s experience is that this can take many years - even after he has made his findings public, which, he says, explains why he is happy to disclose some of his findings in this book. Either most people don’t pick them up or they just think he’s “nuts.”

Your Brain as Enemy

Why is it that, although we know we should buy low and sell high, we often end up doing the opposite? Consider, for example, the month of February 2000 when mutual fund inflows were at their highest and the market was at a peak. That was about the best time to get out, ahead of the ensuing bear market. Then in July 2002, with the market at a low, many investors bailed out in despair, only to see the market take off on a bull run.

This behavior is accounted for by brain processes that evolved for quite a different purpose - keeping us alive in prehistoric times. Our brains are so structured that when information arrives in a form that they are hardwired to receive well, we process it quickly, easily and correctly. When it is in a form we are not hardwired to process well, we are often simply blind to it.

So, if you can understand your brain better, you can understand how to control yourself to avoid making the typical investor mistakes. Ask yourself Question Three: What the heck is my brain doing to blindside me now?

The mental processes at work that can influence our investing behavior include:

- Loss aversion. Research shows that Americans hate losing roughly two- and-a-half times as much as they enjoy winning. A 25% gain feels as good as a 10% loss feels bad. So, people exert more effort to avoid pain than achieve gain. Sometimes, this is referred to as myopic loss aversion, suggesting short-sightedness and an over-reaction to short-term movements. It explains many investing errors, says the author.

- Accumulating pride. Like stone-age hunters, we like to claim credit for our successes, even when they are really down to pure good luck. This gives us an unfounded sense that we can repeat our successes. It’s a natural human tendency.

- Shunning regret. Hand-in-hand with accumulating pride, we try to avoid anything that might cause us regret, preferring to blame external influences when things go wrong. In investing, this prevents us from accepting blame and thus learning from our mistakes. This behavior also leads investors irrationally to hold on to a losing stock in hopes it might recover to a
breakeven point.

- Overconfidence. Out of our accumulated pride grows the belief that we know more than we do. Overconfident investors often have too few stocks, perhaps just a handful, including (or sometimes exclusively) the stock representing their employer, because they think they know the company. The experience of Enron employees who lost all of their retirement savings shows the folly of this. Overconfidence may also encourage some to invest in initial public offerings (IPOs) when the odds of doing so profitably are stacked against them.

- Confirmation bias. As investors, we continually seek fragments of evidence that support our theories and pre-existing notions, while ignoring anything that contradicts our biases. If we find a big name who says the same thing as we believe, so much the better.

- Hindsight bias. This is the tendency to exaggerate the quality of any foresight we had in making a decision, while conveniently forgetting any initial errors. Investors believe they have some sort of special ability or knowledge that leads to a good outcome.

- Order preference. Our instinct is to collect and protect what we have. As investors, we want every piece of our portfolio to do well - a natural instinct but impossible. If we had two initially equal stocks, one of which grew by 25% and the other declined by 10% our instinct is to regret the stock that declined, when what matters is that the portfolio grew overall.

To help combat common cognitive errors, the author suggests we should shun pride and curb overconfidence by acknowledging the role of luck in our successes, and accumulate regret with every loss - accepting our personal responsibility for mistakes, living with them and learning the lessons they carry.

Investors can also use Questions One and Two to challenge or check potential investment decisions.

**Benchmarks and Strategy**

Many investors claim their goal is to beat the market but fail to identify which market they mean and how they will go about beating it.

Two key components of successful investing that support the Three Questions are the use of benchmarks, against which you can chart and measure your portfolio performance, and having a clearly defined strategy that guides your investing behavior. A benchmark can be a well-constructed index that becomes your roadmap in portfolio construction.

By a “well constructed” index, the author means one that is weighted according to the market capitalization of the stocks that make it up. Some - the NASDAQ for
instance - are more volatile than others in the short term because their components are more narrowly defined. Others, like the broadly based, global Morgan Stanley Capital International (MSCI) or All Country World Index (ACWI) display much smoother growth curves because of the diversity of their spread. However, either way, research shows that, over time, most charts end up at about the same place, even if they get there by different routes.

On the other hand, a “poorly constructed” index should be avoided, says the author, citing the Dow Jones Industrial Average. Investors think of the Dow as a reliable market indicator but, in reality, it tells us little and should never be used as a benchmark. For a start, it comprises only 30 stocks, chosen subjectively, and its constituents are weighted according to price rather than capitalization, which results in, for example, a $100 stock having 10 times the impact of a $10 stock, even if the latter is from a firm worth vastly more and much bigger than the former.

Having selected your benchmark, your goal is to perform similarly to it - and beat it if you know something unique. If your benchmark calls for 50% in US stocks, you should only deviate from this if you know something others don’t that might affect the desirability of this proportion. If it calls for 10% energy stocks, that too should be the proportion in your portfolio unless the Three Questions point you towards something others don’t know, leading you to over- or under-weight.

The framework from which you ask the Three Questions will be a comprehensive strategy that drives your decision-making process and keeps you disciplined when you’re tempted to stray.

Your strategy is built upon your investment goals, which most likely will be either to maximize terminal value against a primary purpose, like funding retirement or buying something, or to provide cash flow to cover living expenses. A third possible goal is capital preservation - maintaining the nominal value of your assets without risk - but, typically, investors are looking at terminal value or cash flow, or a combination of both.

But, how do you achieve those goals and start being right more often than wrong?

Building a strategy is as easy as following four rules the author employs every day in managing money:

1. Select an appropriate benchmark. This may be all equity, all fixed income or a blend of the two. The factors in figuring this are:

   Your time horizon; beyond 15 years, an all-equity benchmark is most appropriate since stocks are by far the best performing liquid assets.

   How much cash flow you need; with an inflation-adjusted cash flow of 3% or 4% all-equities are still best but if you want a specific sum without regard for leaving anything for your heirs, a 70/30 split between equities and fixed
income might be appropriate return expectation; again, equities offer the best return over time - individual peculiarity; you might have strong feelings for or against.

A particular company or narrow sector; don’t confuse that with aversion to a whole sector, like tech stocks post 2002 - this is a cognitive error, not a peculiarity.

2. Analyze the benchmarks and assign expected risk and return. This helps determine what exactly belongs in your portfolio. If it’s $200,000 or less, index funds might be appropriate. Above that, you should own individual stocks. Rebalance once or twice a year, unless you suddenly know something others don’t. Then, using a 1-thru-10 scale, assign a risk and return score for each market sector. This is your call and your judgment, says the author.

3. Blend non-correlated or negatively-correlated securities in order to moderate risk relative to return. Make sure your portfolio has elements behaving differently in different market scenarios. For example, sectors with high elasticity of demand perform better in a growing economy than inelastic ones, but the latter do better in a slower economy.

4. Always remember you can be wrong, so don’t stray from the first three rules!

**Conclusion**

The stock market, says Ken Fisher, may be unpredictable but beatable. But you can’t make market bets and win long term unless you know something others don’t.

“I didn’t share some of what I know to wow you with cute analytical tricks,” he says. “It was a demonstration of applying a scientific method to the market. To show you how.”

That is the timeless beauty of the Three Questions. Like Fisher says: “The advantages I showed you will all fade away one day... Yet asking the questions will go on forever.”