How to get ahead in commerce: The sure-fire ways to make money
Transcript

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HOW TO GET AHEAD IN COMMERCE:
SURE-FIRE WAYS TO MAKE MONEY

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Good evening Ladies and Gentlemen. They say that two things fuel the markets, greed & fear. Given the subject of tonight's lecture I hope it was greed for knowledge that brought so many of you here tonight and not just fear of missing the drinks afterwards.

As you know, it wouldn't be a Commerce lecture without a commercial. So I'm glad to announce that the next Commerce lecture will continue our theme of better choice next month. That talk is 'Save The World: A Commercial Break', here at Barnard's Inn Hall at 18:00 on Monday, 28 April.

An aside to Securities and Investment Institute, Association of Chartered Certified Accountants and other Continuing Professional Development attendees, please be sure to see Geoff or Dawn at the end of the lecture to record your CPD points or obtain a Certificate of Attendance from Gresham College.

Well, as we say in Commerce - 'To Business'.

Wise Guys

[SLIDE: HOW TO GET AHEAD IN COMMERCE]

Tonight's lecture was partially inspired by a 1967 film of a 1961 Broadway show of a 1952 book, 'How To Succeed In Business Without Really Trying'. The plot involves a young window cleaner, J. Pierrepont Finch, buying a book describing how to get ahead in the business world. Finch sets out to try the methods shown and, sort of, succeeds in becoming chairman of the board. The moral of the show is that people relationships were more important than business acumen. Having performed the show in secondary school, it always intrigued me whether it had a grain of truth. Are there really easy ways to get ahead, sure-fire ways to get rich?

[SLIDE: SINCERITY PERSONIFIED]

Some years ago I met a very wise guy. He claimed, and had, run the best investment sales team in the world for a couple of years. Their sales of investment products dwarfed those of every other major firm of the time. This guy showed me one of the greatest psychological tricks for closing an investment sale. Imagine the situation: an investment salesperson has just presented a fantastic product guaranteed to produce returns from 20% to 40%, but the punter thinks it's just too good to be true. The pitch line is, 'Do you sincerely want to be rich?' The salesperson closes with, 'Hey Bob, why don't you just pull out your chequebook and write me a cheque for £10,000 so I can invest you in our fund of funds?' Bob demurs, 'I'm not sure I have quite that much cash available.' Then the trick comes, 'Gee Bob, I had no idea you were that hard up. Oh, I feel so terrible about my insensitivity, pushing this product when you've clearly lost so much. Gosh, when I think of you, Jacquie and the kids. The school fees, the dentist, holidays. Just tell me, how much do you need? I've got £80 here you can have right now', which he flourishes under Bob's nose rather publicly, 'and Mary and I can probably scrape together another £20,000 tomorrow that we can lend you?' Naturally, Bob, in a fit of pique, pulls his chequebook out and writes out £10,000 on the spot. A perfect mark.

[SLIDE: SINCERITY CERTIFIED]

This particular wise guy was a key player in a 1960's version of something many of us would easily recognise four decades later, a fund-of-funds. Funds-of-funds are great for sales. 'We'll just take all of your money and invest it in the best-of-the-best of other funds. For a fee of course'. This particular fund-of-funds was Investors Overseas Services (IOS). IOS was founded in 1955 by a Brooklyn psychology graduate Bernard ('Bernie') Cornfeld, and headquartered in Geneva, Switzerland. During the 1960's, 25,000 people sold 18 different mutual funds door-to-door all over Europe, called 'people's capitalism' by Bernie. In some ways, these were easy sales. There was a boom market in shares generally, so the sales people could point to all kinds of valuation figures showing excellent performance of the funds. As long as the boom market continued, valuations would rise and dividends could be paid. During the 1960's IOS raised at least $2.5 billion from 1 million shareholders for IOS' 'Fund of Funds', that in turn meant investment in shares of other IOS offerings, when $2.5 billion was a lot of money (about $20 billion today). IOS grew to about 5% of the global fund industry. The salespeople, like the wise guy I knew, took hefty up-front commissions, nearing 40%. As guaranteed dividends had to be paid straight out of the capital, it was, in effect, a complicated variant of a 'Ponzi' scheme. Once the bull market turned bear, IOS dried up, collapsing in 1970. Perish the thought that this bears any resemblance to the past year's credit crunch, though banks in Europe and the USA did fail because of IOS, and liquidity clearly dried up as values fell in the bear market. As I once cattily remarked to the wise guy, 'anybody can sell a fake product if people want to believe it's real'. In truth, I was jealous; he was one of the best sales people I've ever met.

[SLIDE: PONZI NUMBERS GAME]

A Ponzi scheme is a fraudulent investment operation that involves paying abnormally high returns ('profits') to investors out of the money paid in by subsequent investors, rather than from net revenues generated by any real business. It is named after Charles Ponzi who set up an interesting scam using international postal reply coupon arbitrage in Boston in 1920. Ponzi and pyramid schemes are really rather similar. Technically, a Ponzi scheme is an investment whose value is asserted by paying dividends in excess of actual returns, while a pyramid scheme relies on recruiting new entrants in a chain letter style.

Ponzi scheme returns require an ever-increasing flow of money from investors in order to keep the scheme going. Pyramid schemes require new entrants at the bottom of the pyramid. Many schemes use elements of both Ponzi and pyramid - paying returns out of capital and taking on new investors. In both cases investors are enticed with some kind of fancy theory they, and the sales team, don't understand, e.g. 'global currency arbitrage', 'long-short strategies', 'hedge futures', 'high yield investment', 'absolute value', 'tax efficiency', 'exponential marketing', 'offshore anything' or 'fund-of-funds'. After initial sceptical investors receive a substantial dividend on their initial capital, say 30% in two months, they have an incentive to invest more, and word spreads of fantastic returns. As more people invest the scheme grows rapidly. The problem of course is that the 'return' to initial investors is paid from new investors or capital, not out of profits from the fancy theory.

Of course, all these schemes are doomed. Say you began a small, jokey, and illegal scheme yourself tonight. The rule is simple, 'recruit ten people who will each contribute £100 to their recruiter. Each recruiter passes 90% of what he or she receives to their recruiter'. You will begin with £1,100 and 11 people at level two, but by just level ten you need more people than there are on the planet, i.e. over 10 billion, and about £1 trillion, i.e. much more than half the GDP of the UK for a laugh. Get a bit more serious, say £1,000 per person, and you're getting up to a quarter of global GDP. The power, and absurdities, of exponential growth.

Ponzi schemes go back through the centuries, move forward to Charles Ponzi in 1920, to Reed Slatkin in 2000 and certainly continue today. Ponzi played on Italian-American communities, others play on different discriminations. Sarah Howe in 1880 opened up a 'Ladies Deposit' in Boston promising eight percent interest. Howe's scheme was billed 'for women only'. Unlike Charles Ponzi, Sarah Howe was smart enough to disappear with the money. Ponzi would probably have died a happier and richer man if he'd left town and not been caught, rather than having the fame of donating his name to an age-old scam. We learn so slowly, if at all. In 2004 we had the 'Women Empowering Women' and 'Hearts' 'chain gifting schemes' that could only be broken if women were to 'break a sacred female bond of trust and friendship.' With the state of Social Security in the USA and pension schemes here in Europe, some might argue that our societies happen to have some of the longer-term Ponzi and pyramid schemes at the core of our inter-generational finances.

[SLIDE: DO YOU SINCERELY WANT TO BE RICH?]

Returning briefly to IOS, it's quite a shock to see such strong value changes in just over a generation. The classic book on IOS is the 1971 'Do You Sincerely Want To Be Rich?' written by three Times journalists a year after IOS' collapse. Two anachronistic points stand out. First, thirty years before Enron, the auditors of IOS were Arthur Andersen in one of their first large overseas audits. Instead of chastising Arthur Andersen for negligence, the authors worry that the wool was pulled over their eyes. Second, instead of being outraged by IOS and the inevitable collapse of a pyramid/Ponzi scheme with huge amounts being taken out by the sales force in commissions, apparently many of the investors were not so outraged by IOS. In fact, the authors' ire falls on these investors. People were able to 'invest' in one country and take their 'dividends' out in another, thereby evading exchange costs of up to 95%. The investors' intentions were criminal, given the exchange controls of the time. The authors were outraged that these people evaded exchange controls then in existence in many countries. Today, thirty-seven years later, this indignation is rather amusing as trillions trade around us daily in the foreign exchange markets of London and we expect to be able to move our funds around the world as we please.

So what do we learn about 'sure-fire ways to make money'? First, there is no such thing as 'easy money' unless you know when to leave town. Second, you have to convince people you can make them money. Third, probe deeply and you might find that the key advantages are holes in the systems. In the case of IOS, many investors were willing to lose 50% of their money to IOS as opposed to 95% of their money to government, in order to get their money across borders. Tonight I hope to pull together a taxonomy of sure-fire ways to get ahead, so we might as well start with criminal activity.

A Rich Taxonomy

[SLIDE: GET RICH TAXONOMY]

During Sir Thomas Gresham's life, Thomas Tusser wrote, 'A fool and his money are soon parted.' In the last century WC Fields said, 'You can't cheat an honest man.' So are fools dishonest? In truth, it can be difficult to separate sentiment from scam, as we have seen in numerous recent bubbles from internet to property to credit markets. Kindleberger, in his great book on manias, panics and crashes, devotes a chapter to the emergence of swindles, dwelling on the difficulty of distinguishing a bubble from a scam. And scandals have their cycles. Gailbraith wrote, 'When people are cautious, questioning, misanthropic, suspicious, or mean, they are immune to speculative enthusiasms.' [Galbraith, 1954, page 188] So our first big way to make money is to con people. I don't want to spend tonight regaling you with swindles and scams, frauds, forgery & counterfeiting, tax evasion, embezzlement, robbery & theft, corruption or price-fixing, nor dwell on new ways to separate the gullible and foolish from their money; but you have to note that illegality can pay handsomely.

[SLIDE: WHAT YOU KNOW OR WHO YOU KNOW?]

Smart thinking and hard work will earn you a good living so long as society values it. This value is questionable at certain levels of social cushioning. Still, numerous USA studies strongly correlate household wealth with education. According to the 2004 Survey of Consumer Finances from the Federal Reserve, median wealth varied from over $225,000 for households led by someone with a college degree to under $21,000 for households led by someone without a high school diploma. From 1990 median wealth increased by 37% for those households led by a college degree, while it fell over 40% for those without a high school degree.

Academics and analysts struggle to disentangle inheritance from education and intelligence. There are signs that the middle classes ability to confer educational places on their offspring matters as much as the quality of education or raw ability. Education has become both a positional good and a signalling tool. It is a positional good as the rarer private universities confer higher prestige and status. Education is also a signalling tool, used by prospective employees to demonstrate their commitment to a job or to a profession, as well as ascertain their intelligence, yet not strictly of much use in work. Of course, as more people go to higher education to signal future employers, the more the positional places are simultaneously scarcer. With increasingly universal and global higher education, these private university places are more valuable, regardless of whether they are better. And it works. Take a bunch of bright people and hold on to them for four years, and you still have bright people. Let them loose with a good network and a brand name that says 'this person will succeed', and watch the frequently successful result.

Economists looking to understand decreasing social mobility have noted that middle class households are also handing down their contacts and social networks. Some of this too echoes another aphorism, 'it's not what you know, it's who you know' that matters. Here too, education is another way of building these social networks. MBA marketing literature makes this point repeatedly. The second sentence of the Columbia & London business schools' joint executive MBA online advertising reads - 'Participants instantly gain a global network and have access to two world-renowned faculties, two exceptional alumni networks, ' - But equally powerful networks are built at racecourses, gambling halls, golf clubs, national service (the Swiss) or sports. Of course, if you now 'know how to find whom to contact when', 'what you know' is again what matters.

Looking to the very rich, a number of academic studies have shown that the wealthy tend not to have taken the highest levels of education, and that the more educated you are the less likely you are to be entrepreneurial. So Michael, are you telling us that you went through all that education and those qualifications to tell us that it isn't worth a lot of money? Sadly, yes. If there's a sucker born every minute, it took an hour to make me?

Fortune Favours The Lucky

[SLIDE: SUCCESSFUL HABITS]

But tonight we're examining the sure-fire ways to make lots of money. Who cares about smart people and hard workers? They're so boring! One long-running self-help book is entitled, 'The 7 Habits of Highly Effective People'. This suggests that a scientific way to find sure-fire ways to make money might be to examine the habits of the already successful. This should be interesting. Unfortunately, among the UK's 500,000 millionaires, most of them have the bulk of their wealth tied up in property they bought ages ago. So, with the observation that buying property and holding on to it for a couple of decades has paid off in the UK, though not, for example, in Germany, we might want to focus on people who have made their money rapidly. Perhaps we could just look at figures for people who have gone from average earnings to, say, five times average earnings in five years. They clearly must be on to something.

Unfortunately, such numbers aren't easily available. But let's examine a few illustrative numbers. First, let's take UK median gross annual earnings as about £24,000 in 2007. The top decile, i.e. just under 3,000,000 people, earn more than £47,112. The Institute for Fiscal Studies has broken this down a bit, in the table you see here. Roughly, the top 1% consists of 400,000 people who earn more than £100,000 a year. The top 0.1% consists of 42,000 people who earn more than £350,000 per year. So perhaps we ought to look at what gets people into the top 1% or top 0.1%. Unfortunately, you may not like one clear result - luck.

[SLIDE: SUNDAY TIMES 2007 UK RICH LIST]

You might find it interesting to note that at these numbers, National Lottery winners start to become important; over 2,000 millionaires have been created by the National Lottery since 1994. Far more important is the lottery of birth. Looking at the Sunday Times 2007 UK Rich List, out of the 1,120 people on the list, 226 inherited their wealth. Warren Buffett once told Fortune magazine: 'A very rich person would leave his kids enough to do anything, but not enough to do nothing'. Clearly these 20% of the rich are doubly lucky to have been born to very rich parents who improperly bequeathed their fortunes.

In fact, the Sunday Times Rich List probably understates the amount of inheritance as (1) many of the magnates began with a family-donated nest egg, and (2) people would rather attribute wealth to their own abilities than a head start. Of course, men are over 90% of the top 0.1% and 50% of those are middle aged (45 to 54 years old). Clearly I would regard that as skill rather than luck. Regarding luck, sadly my star sign, Sagittarius, is the worst sign for making money among the super-rich, while any of you Taurans can probably get up now and go collect a free cheque or your lottery winnings. But take a brief stroll on the nasty side for a moment alongside Jean Cocteau - 'We must believe in luck. For how else can we explain the success of those we don't like?'

[SLIDE: FORTUNE FAVOURS THE LUCKY]

In past lectures we've examined a number of related thoughts on why people participate in games with bad odds such as lotteries. Again, rather than dwell on the irrationality of gambling, I'd like to move on to some of the other sure-fire ways to make money. To do so, we'll turn to basic economic theory about market failure. The four classic market failures are lack of competition & scarcity, information asymmetries, externalities and agency problems. Each of these has featured in previous lectures, so I'd just like to refresh your memories briefly.

Getting Rich Through Failure

[SLIDE: GETTING RICH THROUGH FAILURE]

The first classic failure is lack of competition & scarcity. If there is any way in which someone can obtain a monopoly or restrict competition, there await riches. EU competition policies and USA anti-trust rules are attempts to ensure that markets remain competitive. Competition is crucial to markets. Without competition there is no innovation, no creative destruction and no motivation for the 'invisible hand'. Equally, business people love to form cartels, fix prices, restrict market entry and obtain state aid and subsidies. If something isn't scarce, make it scarce. From Roman salt taxes, to mediaeval guilds, to Tudor monopolies, to airlines & airports fixing prices, to research & development subsidies, to professional service restrictions and financial services firms abusing state guarantees, we see that a lack of competition can help some people become rich. The US robber barons gained their riches by controlling monopolies in oil, mining, steel and railways. The Russian robber barons gained their riches by controlling similar monopolies.

We continue to find monopolies in modern industries such as broadcasting, software and biotechnology. Monopoly and competition problems accompany powerful standards or state-imposed bureaucratic procedures that enforce or favour certain firms. More subtle problems accompany 'created' or artificial scarcity such as cornering markets. Bill Gates and Microsoft have had their share of run-ins with anti-monopolists. But now that Gates has left Microsoft for philanthropic work at the Gates Foundation, it's interesting to see he hasn't left monopoly accusations behind. Dr Arata Kochi, a leading public health expert on tuberculosis and malaria at the World Health Organisation, has points out the problems of beneficent monopolies, 'Gates can solve problems with money - but a lot of money leads to a monopoly, and discourages smaller rivals and intellectual competition.'

The second classic failure is information asymmetry. 'People often have access to different information or are uncertain about its reliability - described as *information asymmetries* - so their decisions will be formed accordingly.' [Coyle, 2007, page 149]. We discussed at length in a lecture last year how information asymmetries lead to problems in markets, for example the market for used cars (the market for lemons) - 'Fads And Fashions: If They Are So Bad, Why Are They So Rapidly Rich?', 17 December 2007 - http://www.gresham.ac.uk/event.asp?PageId=39&EventId=642.

The third classic failure is agency problems. These include lots of contractual problems, such as executive compensation or perverse incentives from too-frequent benchmarking. When you find that your fund manager is thinking about his or her annual bonus rather than your pension, you have an agency problem. We discussed agency problems last year when we looked at corruption - 'What I Like About This Country Is That It Has A Nice Level Of Corruption!', 4 October 2007 - http://www.gresham.ac.uk/event.asp?PageId=45&EventId=646.

The fourth classic failure is categorised as externalities. Externalities are, basically, not having to pay for things that cost other people. Externalities don't matter to the economic system, but do matter to society. The classic example is pollution. If you can pollute while manufacturing something, while I have to pay to keep the local river or land clean, you have an advantage over me. Carbon emissions are a good example of a several millennia old externality that is starting to be 'internalised', that is, we are starting to have to include the costs of carbon emissions in our economic and financial calculations. We have had the advantage over future generations. Another good example might be court cases. The legal system is an externality. The vast majority of economic activity is based on trust and rarely setting foot in a courtroom. An economic sector, say construction or health, that had a high degree of mis-trust would result in a larger number of court cases. The legal system costs would borne by all economic sectors through taxation. The other sectors bear the costs of this externality.

[SLIDE: BARKING UP THE RIGHT TREE]

I have rattled through these four failures to remind you that they exist. If you are in the fortunate circumstance of holding a monopoly or top secret information or a hold on a client or aren't getting charged for something you should, you're probably staying quiet. However, market failures can be relative. In the late 1980's the father-in-law of a colleague had a locally dominant sawmill (monopoly & scarcity). People sent him their wood assuming that the bark was worthless (information asymmetry) and trusting him to get a high lumber yield from the trees they sent (agency problems). He blasted the bark off trees and put it in a nearby waste pit he owned, not paying landfill costs (externality). Suddenly, the market for bark chips and bark mulch rocketed. My colleague's father-in-law began mining the waste pit at great profit. So what's the moral of the story? His avoidance of the externality costs allowed him to stockpile a valuable resource for free, but you can credit him neither with defrauding his customers nor foresight. You could, though, deploy another aphorism, 'where there's muck there's brass', pointing out that tomorrow's valuables are very often today's waste.

The biogeographer Jared Diamond, who concluded an essay on 'How To Get Rich' with observations about competition and information sharing:

'So what this suggests is that we can extract from human history a couple of principles. First, the principle that really isolated groups are at a disadvantage, because most groups get most of their ideas and innovations from the outside. Second, I also derive the principle of intermediate fragmentation: you don't want excessive unity and you don't want excessive fragmentation; instead, you want your human society or business to be broken up into a number of groups which compete with each other but

which also maintain relatively free communication with each other. And those I see as the overall principles of how to organize a business and get rich.'

Jared Diamond, 'How To Get Rich', Edge 56, 7 June 1999 -http://www.edge.org/3rd_culture/diamond_rich/rich_p1.html

Diamond's observations imply that centres of free trade with open borders and numerous connections will make money - London, Hong Kong, Singapore, perhaps Dubai - even without natural resources. Of course it helps if you can add an intelligent workforce, benign government, good regulation, good infrastructure and macro-economic stability.

So, if you can't create a monopoly, as so many professions do at least partially, lawyers, accountants, doctors, to name a few; and you don't have private information; and you can't appropriate other people's assets; and you have to pay full whack for waste and other societal costs; what's a get-rich-quick merchant to do? In other words, assuming that markets are well-regulated, is there a strategy to succeed? Yes, two sure-fire ways really.

Front-Running Bubble Style

[SLIDE: GETTING RICH THROUGH BUBBLES]

The first sure-fire way is to see if you can 'front run' a bubble. Can you anticipate what the 'next big thing' will be? If you can, then a host of opportunities await. Front-running takes advantage of the fact that markets can never be optimal. To find the optimum level of supply and demand, or the optimum level of investment, markets always overshoot. Again, we covered some of this a while back when we examined the 'Perceptions Rather Than Rules: The (Mis)Behaviour of Markets', 14 November 2005 - http://www.gresham.ac.uk/event.asp?PageId=4&EventId=443. A common criticism of markets is that they are wasteful. As markets move towards equilibrium they must be at least slightly wasteful. They must overshoot or undershoot a little. The presumption of a central planner though, is that one person can calculate supply and demand exactly. If the boom and bust are semi-predictable, then sure-fire ways to make money might exist if we can just predict the 'next big thing'. Michael S Malone observed that 'Money makes the world go round. True. But desire really makes the world go round - and money is just desire's way of organizing itself.' And desires are something about which we, as people, know everything.

In mediaeval times, the next big thing was religious - the Holy Grail, saintly bones, shrouds, fashionable pilgrimages or challenging quests; or sacrilegious - alchemy, witchcraft or freemasonry. In early modern times the next big thing was the newest spice or exotic land. In more modern times the next big things were socio-political ideas such as Adam Smith's invisible hand as well as in its nemesis communism, let alone fascism, socialism and other ism's. Arguably, it is only in the past two centuries that technology has been accepted as a worthy, and consistent, lode for mining the next big thing. Technology has been a deep lode, from mass-produced steel to textile machinery to electricity to magnetism to railways to vaccines to plastics to atoms to computers to designer drugs to biotechnology. In the 1967 film The Graduate Dustin Hoffman's character, Benjamin Braddock, is given one word of advice by his father's friend, Mr McGuire, 'plastics'. In the 70's the word was 'computers', in the 80's 'internet', in the 90's 'biotechnology'. Mr McGuire was right, following the trail of Bakelite, any number of plastics were big. Mr McGuire showed that, oddly, you could see the next big thing coming. The next big thing is virtually the 'present big thing' and it's always some new technology.

[SLIDE: FRONT-RUNNING BUBBLE STYLE]

Several next technological generations already exist in research laboratories. It's very small - quantum computers, smart dust, light-emitting organics. It's very large - hydrogen power, renewable energy, space colonisation/power/shading/elevators, the global nervous system. It's cheaper - micro-power, artificial food, disposable and foldable electronic paper computers. It's faster - on-demand layered machinery, real-time chip programming, bio-nano-hybrid bugs. It's specific or user-friendly - personalised drug design, mentally-merged machinery, dynamic anomaly and pattern response. Barring the demise of the human race, we must assume these things are likely to arrive simply because they are possible. The necessary business skill is correct application and timing.

One important characteristic of the next big thing is that it must have the power to surprise at the time it starts to become big, but surprise only a little bit. Talk about quantum computing with most people today and their eyes glaze over, much as most eyes glazed in the early 90's when you discussed a world-wide network. It's not whether you can see it coming; it's whether your neighbour doesn't, but only by a little bit. Your neighbour must find it almost immediately plausible and credible, but at least slightly surprising. Your neighbour must also share the perception that the next big thing has the power to disrupt the current order. The next big thing is about changing perception more than prediction. Today, a green energy bubble may be emerging from the froth of climate change debate.

Fortunes can be made by concentrating on the next big thing. Mark Twain's contrarian, anti-portfolio investment strategy (from Pudd'nhead Wilson) makes a virtue of focus and concentration:

'Behold, the fool saith, 'Put not all thine eggs in the one basket' - which is but a manner of saying, 'Scatter your money and your attention', but the wise man saith, 'Put all your eggs in the one basket and - watch that basket''

Of course, you can always be too late for the bubbles. I have friends who were in the Middle East in the 1970's, in the City in the 1980's, in eastern Europe in the early 1990's, in Russia and the internet in the late 1990's, and property in the mid-2000's. They're always out to make a quick buck from the next big thing, but slightly late.

Money Machines

[SLIDE: GETTING RICH THROUGH MAGIC]

The second sure-fire way is to build a 'money machine'. A money machine is anything that convinces other people they can make money with you. It can be a get-rich-quick book, and there are plenty. Of course you must ask why someone who is truly rich going to be bother to write a get-rich-quick book, but then few people ask why Warren Buffet writes his open letters to shareholders setting out his 'value investing' approach. There are some interesting subtleties to Buffet's approach, but at a high level his 'value investing' approach means buying companies because 'they are cheap compared to their intrinsic value'. Not exactly rocket science. Another popular book, Rich Dad, Poor Dad, which makes a virtue of a lack of formal education, teaches key lessons such as to buy assets that produce returns. As a final parody, dwell on these deep nuggets from a business network site (http://findarticles.com/p/articles/mi_qa3642/is_200003/ai_n8891853):

1. Invest in good businesses with superior growth and profitability.
2. Focus on high-quality companies, particularly those with strong competitive positions.
3. Concentrate on the long term.
4. Be willing to go against the consensus.
5. Pay close attention to value.
6. Diversify.

Why would you do anything different? Why not invest in poor businesses, buy rubbish firms, be very short-term, follow everyone else, ignore value and make one big bet?

Lack of competition & scarcity, information asymmetries, agency problems and externalities lead investors to focus on brands, brand value and solid returns, which is actually a fairly rational response. Large firms with large brand footprints and solid returns are signalling that they are here for the long-term and not founded on transient advantages. I'm not claiming that there aren't some interesting nuggets in these self-help or get-rich-quick books, but it's also very hard to determine whether they're of any use. Naturally, I'm not alone. Everyone wants these writers to prove that their books' get-rich-quick methods work. The writers invoke, quite understandably, their own track record of success. The problem is that the writers' successes and their method may or may not be related. You can be successful with many different routes under the Buffet scheme. It's also unclear whether many of these people actually follow their own schemes slavishly, either rationalising all past events to fit their rules, or regaling readers with a version of the hard-and-fast rule - 'know when to break your own rules' rule.

Another book writer, Nassim Nicholas Taleb, points out that the null hypothesis for most of these methods is just luck. Luck, with post-hoc rationalisation. Echoing a thousand monkeys producing the works of Shakespeare, Taleb says of the likes of Buffet, 'All I need is to show that there exists an alternative explanation to the theory that he is a genius. My approach is to manufacture a cohort of intellectually challenged persons and show how a small minority can evolve into successful businessmen - but these are the ones who will be visible. I am not saying that Warren Buffet is not skilled; only that a large population of random investors will *almost necessarily* produce someone with his track records *just by luck*.' [Taleb, 2004, page xv] Or as one of my favourite authors, Iain M Banks wrote in his latest book, Matter, 'One hundred idiots make idiotic plans and carry them out. All but one justly fail. The hundredth idiot, whose plan succeeded through pure luck, is immediately convinced he's a genius.' [BANKS, Iain M, Matter, Orbit (2008), page 281]

Taleb's own get-rich-not-so-quick scheme, with which I have much sympathy, is to bet on extreme market events being more likely than they are. This system is in keeping with the (Mis)Behaviour of Markets as human systems are systems that exhibit feed-forward rather than physical systems with objective, observable frequencies of events. Much effort goes into separating luck from skill in investment appraisal. Sharpe ratios were one attempt to analyse investment management performance by regressing returns against benchmarks - is it stock-picking? is it leverage? is it the sector? 'Many [hedge funds] that appear hot are merely the beneficiary of a risky quirk, such as leverage'. ['Hedge Funds: In The Garden Of Good And Evil', The Economist (10 September 2005), pages 78-81] Paul Samuelson feels it is useless to try and identify genius investors because you cannot determine in advance who they are, and afterwards its too late.

[SLIDE: BLACK BOX MACHINES]

There are other approaches than publishing books. Publishing software works too. Every few months my firm is approached by someone with a black box for market trading. Typically, this is a piece of trading software that, had it been used for the past few years, would have made the owner pots of money. Naturally, the request is for our firm to raise £millions for the inventor/programmer to use for market investments so that we can all make pots of moolah in the future. A reasonable question is, if this or that black box for market trading is so good, then why didn't the inventor just patiently build up his or her millions without seeking to raise investment. The usual answer is that the system only works if it's done at scale. One can always fit an algorithm to historic market data, using an infinite number of methods. The difficulty is dealing with a discontinuous future. Most of these black boxes for market trading work for a while but then break down, especially when transaction costs are taken into account.

These black boxes violate efficient market theory and skewer their creators on the horns of a dilemma, are they intelligent or do they have integrity? If the creators genuinely understand markets and prevailing theory that says markets can't be beat in the long-term, consequently they must be holding themselves forth as unparalleled geniuses. Or are they lying to us and themselves to get our money to manage? But the black boxes never stop coming. Interestingly, they have their seasons. Black Boxes are more common in bull markets than bear markets. Galbraith similarly remarked on speculative seasons: 'Far more important than the rate of interest and the supply of credit is the mood. Speculation on a large scale requires a pervasive sense of confidence and optimism and conviction that ordinary people were meant to be rich. People must also have faith in the good intentions and even in the benevolence of others, for it is by the agency of others that they will get rich.' [Galbraith, 1954, page 187]

[SLIDE: MONEY MACHINES]

A related observation is 'sticky fingers' - the cabbage farmer's family is never short of cabbages, the coal miner's family is never short of coal and the woodcutter's family is never short of wood. If we can just get ourselves into the money-farmer or money-miner situation some of that moolah is bound to stick to us. Which leads us to consider investment managers, our money-farmers and money-miners. We trust them to speculate with our money. And in the UK and many other countries, these investment managers start with a huge tax advantage. Sadly, their performance, even with a 40% tax advantage, is often not worth bragging about, particularly after their own fees are deducted. Yet we still give them our money, which sticks to them the same way that coal dust sticks to the coal miner. They take credit for the rises, avoid blame for the falls, and take their commission each year without fail. Without the government-enforced tax advantages you might wonder if they would exist, but that is to ignore human nature. These money-managers would exist in any case, because we want to believe in money-making machines rather than luck.

[SLIDE: GET RICH TAXONOMY]

A number of people query my scepticism about the existence of successful investment trading strategies for the average person.   If markets are so efficient, if we doubt get-rich-schemes and if super-fund-managers possess luck rather than intelligence, why do proprietary investment bank trading operations (i.e. when banks trade on their own account rather than just execute client orders) do so well in most years? This is a good question with an answer that underscores our four market failures:

- competition & scarcity: the investment banking industry, despite its protestations, is not that competitive. Most of the major firms today existed 80 years ago. It's difficult for outsiders to get access to trading markets at competitive prices. Regulation keeps new entrants to a minimum. Many of the investment banks would make a fantastic income just taking their clip of fees on their own retail and commercial client base. Banks often lie to themselves. In several cases, when you look at proprietary trading, the banks would have been better to have just serviced their clients rather than try and look smart;

¨ information asymmetries: investment banks know far more than their clients about true prices, for example the price of an IPO. Too frequent benchmarking drives their behaviour to short-term actions or even lying to clients, e.g. a low-risk fund that creates situations where it 'needs' to invest in risky overnight instruments, thus exceeding its benchmarks in most years, except the year it goes bust. The very order flow of clients' trades lets firms know which bubble is inflating and which deflating. Investment banks make money on directional trading because they know the flow of trades. Naturally, they are ahead of the game both ways. I won't even mention insider trading;

¨ agency problems: firms always promote investment schemes they've been unable to fill. The money sections of the papers, particularly the Sunday papers, are always full of schemes everyone in the City knows aren't selling. Further, negotiating investment management fees is a mug's game. If the investment manager has a particularly good recent record, meaning he or she is likely to falter, then they demand high fees. If the investment manager has a particularly poor recent record, meaning that regression to the mean is a possibility, you don't want to invest no matter how much they discount their fees;

¨ externalities: the biggest externality is the next period. Investment banks are encouraged to push everything into an annual cycle, which is certainly too short a cycle for most pensions (well, at least before the final year), annuities, long-term endowments and many other schemes. Worse, the investment banking industry's annual bonus cycle means that decision horizons are, on average, six months; people are so busy contemplating job-hopping in January and February that they don't care about results till later in the year; people can execute strategies that fail massively one year in ten, but not bear the consequences most of the time; with everyone shifting every couple of years all investment banks look alike in strategy, people and results; and finally that the people who take your money aren't the people that manage it and aren't the people that might carry the can if the results are less than satisfactory ten or twenty or thirty years later.

And investment banks don't neglect our two sure-fire ways either:

¨ front-running: not only can they spot bubbles emerging, they work to create them, as was so noticeable during the dot.com bubble when the promotion and 'research' of dot.com IPOs fatally inflated the bubble;

¨ money machines: in conjunction with asset and investment managers, investment banks are able to sell us on their skills, stick their sticky fingers on investments and, ironically, even promote their own firms as money machine investments to us.

Owning The Casino

[SLIDE: GREED, FEAR, AND A LITTLE GAS]

The 'Seven Blunders of the World' is a list that Mahatma Gandhi supposedly gave to his grandson not long before his assassination. The blunders are:

¨ Wealth without Work;
¨ Pleasure without Conscience;
¨ Knowledge without Character;
¨ Commerce without Morality;
¨ Science without Humanity;
¨ Worship without Sacrifice;
¨ Politics without Principle;
¨ to which his grandson, Arun Ghandi, added an eighth, Rights without Responsibilities.

Intriguingly Gandhi's first blunder is 'Wealth without Work', believing in money machines. So you should manage your own money, right? Elbert Hubbard quipped that 'Genius may have its limitations, but stupidity is not thus handicapped.' Yet we don't want to manage our own money. We want to believe in the money machines. We expect these slot machines to pay out sometime. We don't want to be left behind the thundering herd.

We are driven by fear and greed, while the investment community piles on a little gas. This leads to an inevitable conclusion. If hard work and smart thinking don't pay, if markets are just casinos, and if people will always want to get rich - then why not own the casino? What the investment banks realised long ago, as have various stock exchanges, betting exchanges, eBay and, slightly differently, Amazon, is that it pays to own the casino. Why not have a monopoly on the entire market?

So what have we learned? Well, one guaranteed way to make money is to convince people that you have a sure-fire way to make money. Unfortunately, if you have self-esteem, you are likely to be hoist on an intelligence versus integrity see-saw. The second best way to make money is to ride a bubble and get off in time, but you have to be intelligent at guessing what other people will desire. In short, leading people into scams is dishonest, but successfully predicting where people will go constitutes honest investment winnings. Finally, if people are going to trade with each other anyway, find a way to own the casino. Perhaps that is the surest way to make money. And maybe in a future lecture we can explore how to keep it.

[SLIDE: DISCUSSION]

Thank you.

Discussion

1. When should we let third parties invest our money, ignoring tax advantages?

2. Do regulatory and professional safety costs genuinely offset caveat emptor, or just take our money?

Further Reading

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Further Surfing

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2. On Gates Foundation criticisms -http://www.economist.com/world/international/displaystory.cfm?story_id=10729975 & http://www.nytimes.com/2008/02/16/science/16malaria.html?ex=1360904400&en=fcb3635582aeb197&ei=5088&partner=rssnyt&emc=rss

3. One typical example of get-rich sales technique, Tony Quinn -http://www.esatclear.ie/~dialogueireland/a2z/tq/medicineman.htm

4. Gandhi's seven/eight blunders - http://en.wikipedia.org/wiki/Seven_Blunders_of_the_World

Thanks

I would especially like to remember Eli Wallitt who passed away a few years ago. Eli opened my eyes to many of the problems with third party investment and inspired many other thoughts. He is one wise guy I miss.