Do you have an investment philosophy?

This is a very simple question whose answer has far-reaching implications for your life savings and retirement peace of mind. I have asked this question to hundreds of people only to get the normal deer-in-the-headlights look or the confident "Yes, mine is moderate," or "Yes, mine is conservative." I am not speaking to your investment objective and risk tolerance, but to the core underlying philosophy you are applying to your investments.

There are basically two investing camps in the industry. One thinks the market is efficient, and other that it is inefficient. Most people (specifically, investors) have never really thought about it. It is tremendously important as an investor for you to define this belief structure for yourself. Most investors have never had this opportunity. They simply use the latest investment strategy or the one their neighbor successfully used. But I know that once you are clear about your belief, what you truly believe, it will tell you how you need to manage your money.

Let's get into some of the science of investing. Meet professor Eugene Fama, who, in 1965 in his PhD dissertation, said, "In an efficient market at any point in time the actual price of a security will be a good estimate of its intrinsic value." In simple terms, the price of a good or service is based on supply and demand, and the free market will dictate what is paid.

To understand free markets, let's explore the inefficient-market approach. This means that markets consistently misprice goods and services. Therefore, it would be reasonable (if that were true) and possible to take advantage of the mispricing and pass value on to the investor by increasing returns and avoiding losses in investments. People who believe the market is inefficient would utilize traditional investment strategies, market timing, stock picking, track-record investing, and other speculative practices. If someone could predict market movements, what's their motivation for telling you?

There is another view of the market, and it's based on the efficient-market hypothesis. This view tells us that, based on supply and demand, the free market is the best determinant of market prices. All available information is factored into the current price. Only new and unknowable information and events change pricing into the future. The randomness of the market makes it impossible for any individual or entity to consistently predict market movements and capture additional returns unrelated to risk.

So, there are two completely different ways of looking at the world. In this age of grays, this decision is black and white. Attempting to believe a little bit of both and taking actions based on this murky belief will, without a doubt, give you disappointing performance on your investments. You simply can't have it both ways. Because, if you think that markets are inefficient, then you must continue trying to take advantage of these inefficiencies through stock selection and market timing. On the other hand, if you believe that markets work, then the appropriate action is to try to find something else, something that works better.

This view would appear to be consistent with the many studies conducted over the past 50 years in the field of economics and, specifically, the field of investments. This research is conducted through some of the leading universities in the country, including Yale, Stanford, and, most notably, the University of Chicago. The University of Chicago has been the home of the research for more Nobel Prize winners in the field of economics than any other institution. You might improve your chances of becoming a successful, wealthy investor by studying the writings of these brilliant individuals, and avoiding the sales traps that can be lurking in traditional investment methods. ■

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