My Investment Letter: Words of Advice for My Grandchildren

One of the great joys of my life is seeing my four young grandchildren growing up: learning to crawl and then walk, learning to talk and read stories, learning to ride bikes and play computer games—learning in all directions how to do all sorts of things. Of course, they want to do all these things well: It's more fun and wins praise.

It is way too early for my grandchildren, all under 10, to learn what they'll need to know—and will want to know—about how to be successful at investing. But that time is surely coming, and being successful in investing will be very important.

After 50 fascinating years of working closely with nearly 100 investing organizations, knowing many of the world's most effective and successful investment managers, teaching the advanced investment courses at both Yale and Harvard, writing over a dozen books and serving on 14 different investment committees, I've received a remarkable and treasured education in investing: theory and concepts, professional "best practices" and the realities of investing's history.

Having enjoyed this remarkable learning opportunity, I'd certainly like to share my understanding of investing with my adorable grandchildren. But, by the time they'll be really interested in learning about investing—in, say, 20 years—I may no longer be around. So what can I do?

I decided to write an investment letter to my grandchildren. I knew it should be brief so reading it would not be a chore. While "timeless" may sound a bit highfalutin, my message certainly should not be dated or too tied to one specific time or era. It should be appropriate for my grandchildren to use at any time and in any economy or any stock and bond market.

Since my grandchildren will probably open my letter when they are in their twenties—when they will have another 50 or 60 or even 70 years to live and invest—the letter should focus on truly long-term investing. Finally, since the chances are that they will not make their careers as professional investors, my letter should assume that my grandchildren will be consumers, not producers, of investment services.

Since most people don't like getting advice unless they ask for it, each grandchild's letter is in an envelope with his or her name on it and this sentence: "Please open only if and when you have decided you'd like to get some ideas about your investing from your loving grandfather." Inside each envelope is my letter.

The Letter to My Grandchildren

Dear Jade (or Morgan or Ray or Charles),

You decided to open this letter hoping to get some ideas about investing that you'll find useful and helpful. Naturally, in writing up these ideas for you, that's my hope too. So in writing this letter, my rule has been KISS – Keep It Short 'n' Simple.

You probably know that investing can be complicated, so this could have been a very long letter. (If you ever want a longer explanation of how to succeed in investing, you can always read my "Elements of Investing: Easy Lessons for Every Investor" [updated edition, John Wiley and Sons, 2013] or "Winning the Loser's Game" [6th edition, McGraw-Hill, 2013], which has sold over 500,000 copies.)

Two suggestions: If, after reading the letter, you decide you're not yet all that interested in thinking seriously about saving and investing, put the letter back in the envelope and reopen it in about five years. If you're still not very interested, retain the valuable services of a professional investment adviser to guide you as you make your own decisions.

If you decide you are seriously interested in learning about investing, keep a diary of your investment decisions: what you expect of each investment when you make it and, later on, how the results compare to your original expectations. Like a videotape of tennis or skiing, this objective feedback will help you learn—both more and faster—how to do your best in investing. (As in driving, the secret to success is simply not making big mistakes.)

12 Investment Guidelines

Here are 12 investment guidelines to consider. Naturally, I hope you'll find each of them useful.

1. Since you'll be investing for many years—you'll continue investing for at least 50 years—invest always for the very long term. Over the long term, the highest average returns are achieved with stocks. So, except for a modest "in case of emergencies" savings fund, concentrate your investing in stocks. (Before investing in bonds, give serious consideration to #11 below.)

2. Since nobody can know which companies and stocks will do "better," always diversify your investments widely. An important reality explains why: "Better" in investing really means better than expected by the full-time professional investors who have superb information and now dominate the stock market and set all the prices. (As I write this in 2013, professional investors do over 95% of all NYSE trading, up extraordinarily from less than 10% 50 years ago.)

As my friend Burt Malkiel [author of bestselling "A Random Walk Down Wall Street" (10th edition, W.W. Norton & Company, 2012) and co-author of "Elements of Investing," a two-hour read that covers all the basics] so wisely says, "Diversification is the only free lunch in investing."

3. When observing the short-term behavior of the stock market, ignore the day-to-day and the week-to-week price gyrations and news reports. Concentrate instead on longer-term averages or norms. Just as when buying a home, you would ignore thunderstorms or a heat-wave—the daily weather—but would think carefully about the area's overall climate, always take a long-term view.

Remember that when stock prices go down that's actually good news for long-term investors, because you can buy more shares with the same dollars.

Also remember that Mr. Market—a colorful, tricky rascal—is always trying to capture your attention and get you excited or upset so he can trick you into buying or selling by moving stock prices around. Don't let him ever interfere with your steady focus on the discipline and serious work of building long-term investment value.

4. Minimize trading to minimize costs and taxes. Never make an investment you don't expect to stay with for at least 10 years, and hope to stay with for 25 years. If you invest this way, you'll not only save on taxes and trading costs, you'll teach yourself to make better investment decisions before you act. That's why Warren Buffett suggests we all limit our lifetime investment decisions to 10, so we'll oblige ourselves to make more careful, thoughtful, long-term choices whenever we do take action.

5. Consider low-cost indexing very carefully. By reliably and consistently delivering the market rate of return with broad diversification and very low turnover (and so incurring low costs and taxes), index funds outperform a substantial majority of all mutual funds with similar objectives (i.e., growth, value, small cap, international, etc.) Those who know the most about investing agree that index funds are best for most investors. (Always check the fees to be sure you invest in low-cost funds.)

6. Beware of fees. They may look low, but they are actually very high when looked at realistically. Yes, most investors innocently describe mutual fund fees with one four-letter word and one number, but both word and number are wrong! Conventionally, we say mutual fund fees are “only” (the four-letter word) 1% (the number). But 1% of what? Your assets! Since you already have your assets, you are paying for something else: a return on your assets.

So, calculated as a percent of returns, that 1% of assets is closer to 15% of returns (if the consensus expectation of 7% returns holds). That 15% is a lot more than 1%—and nobody would say “only” 15%. But even 15% would be misleading.

As we all learned in Economics 101, every price should be compared to the price of every alternative good or service to reveal the incremental price of each alternative compared to its incremental value. (That’s what smart shoppers do at the grocery store and what savvy diners do when studying a menu or a wine list.)

So, the incremental fees for an actively managed mutual fund relative to its incremental returns should always be compared to the fees for a comparable index fund relative to its returns. When you do this, you’ll quickly see that that the incremental fees for active management are really, really high—on average, over 100% of incremental returns!

7. While the past does not guarantee the future, understanding investment history is certainly the best way to understand how best to invest. So here are a few of the lessons of history:

- Index funds achieve higher long-term returns than most actively managed funds, particularly after fees and taxes.
- Index fund fees are less than 1/10th as much as the fees of actively managed funds.
- Index funds incur much lower taxes.
- While index funds will never have “beat the market” results, they avoid the bane of active management: underperformance.
- Unlike active managers, index funds reliably and consistently achieve their investment objective—every day, every month, every year, and every decade.

So please consider indexing carefully for all or most of your investments.

8. Active investment management is always “interesting,” and in the short run, can be exciting—or painful. But be careful, because so many brilliant, imaginative, hard-working, extraordinarily well-informed, full-time professionals have flooded into investing institutions all over the world and are now competing with all the others all the time. So it cannot be surprising that their collective best judgments—while necessarily imperfect—have become so good that by the millennium, two major changes were evident to careful observers. It had become difficult for any active manager to beat the market over the longer term and, equally daunting, it had become virtually impossible to figure out in advance which individual active managers would be the lucky ones that would beat the market.

9. Fortunately for you, finding managers who would beat the market—which used to be many investors’ goal when markets and investing were so different back in the 1960s and 1970s—is not nearly as important for your long-term investing success as knowing yourself.

What really matters most is figuring out—often best done with a professional investment adviser—the long-term investment program that is best suited to you: your financial resources, your spending objectives, your time-horizon and your ability to stay the course. Remember always that for long-term investment success, you are more important by far than the stock market and more important than active managers. So take the time to "know thyself" financially. Once you have done this well, your other decisions will be much easier to make and your decisions will be better matched to your true objectives.

10. Most investors who do not succeed have made at least one—and sometimes all—of three "classic" mistakes. Please be sure to avoid all three.

Trying to beat the market. Some folks do beat the market each year, but usually only because they got lucky. (While most patrons at gambling casinos lose, there are "lucky winners" every day, which keeps the gamblers coming.) Most investors who try to beat the market fail and, if honest with themselves, wish they had never tried. Besides, you'll have many much better things to do with your time than chasing after will-of-the-wisp "investment opportunities."

Borrowing on margin to really beat the market—and then getting caught short. Leverage works both ways. So be careful.

Buying after stocks have gone way up, particularly buying the stocks that are up the most, or selling at the bottom after stocks have gone way down and converting a temporary loss into a permanent loss.

11. Try always to see the whole picture when you make financial decisions. For example, your salary or earned income—with its predictable cash payments for your knowledge capital—will be similar to interest income from owning bonds when you lend your financial capital, or savings. What this means in a whole picture view of your financial situation can be surprisingly important.

If interest rates are 5%, the equivalent market value of your knowledge capital would be 20 times what you get paid in salary. So, if you earn $100,000, that part of your knowledge capital financial whole picture would be a lot like the income from owning $2,000,000 in bonds. Recognizing this reality, you may decide that also holding substantial investments in bonds—often recommended for portfolio balance—does not make much sense when you are less than 50. (When you're approaching retirement, you may want to replace all or part of your salary income gradually with income from bonds, particularly if market price fluctuations cause you serious distress.)

12. Saving is always the first step toward investing. Time is important too. In combination, time and saving—compounding—can be very powerful.

Sensible investing lets money make money for you. Here's an example. The amazing Rule of 72 tells you for any interest rate how many years it will take to double your money. At 8%, it takes nine years; at 10%, it takes 7.2 years; and at 3%, it takes 24 years to double—and the same number of years to double again, and so on. So if you save $5 today and invest it at 6%, in 12 years, it will be $10; in 24 years, $20; and in 36 years, $40. So when you save $5, try to remember that it wants to be $40 that you can spend in the future (after, of course, adjusting for inflation).

Indexing Is a Lot Like Flying

My father in-law was an expert U.S. Navy pilot. He was an Annapolis all-American athlete, commander of the USS John F. Kennedy when it was the world's most powerful warship, a two-star admiral and the world record-holder for one of the most dangerous actions in naval air: landing a fighter—bomber—on a carrier…at sea…at night!

In all his flying career, Admiral Koch never had an accident. I fly a lot too: 10 overseas trips a year and dozens of domestic flights. My record is perfect too: no accidents in over 60 years of flying. So, we both have been safe flyers.

But my flying is a lot like indexing: very deliberate, reliable, safe, no excitement (dull, really), no important skills required of me, and (on a cost per mile basis) low cost. All I need to do is decide where and when I want to go, make a reservation, get to the airport on time, check in, go to the right gate, sit in the right seat, and buckle the seatbelt.

While the highly skilled and well-trained pilot and crew are doing all the work, I've got better things to do with my time—like writing this letter to you with the hope that you'll find these ideas about investing useful to you as you decide how you will design and manage your investment program for success over the very long term.

Your loving grandfather, Charley

Advice I Wish I Had

Any grandmother or grandfather reading my letter will understand exactly how I chose my 12 investment guidelines, and they'd be right. The guidelines are what I most wish I'd been given when I started out 50 years ago. If I'd only known—and, of course, used—these guidelines, I'd have avoided some costly mistakes.

Fortunately for me, my fortunate education in investing taught me enough great lessons soon enough that I was able to enjoy many years of investing success.

Not everyone will be so lucky, so they will need professional help—not on beating the market, but on defining and sensibly solving their own unique investment problem.