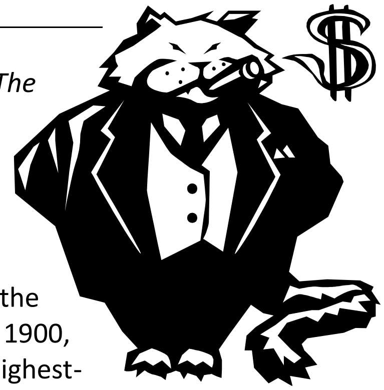
Want To Make $1.3 Quadrillion?



At the close of the twentieth century, the editors of the financial magazine *The Economist* identified the highest-returning investments for each year, beginning in 1900 and ending in 1999. For example, the highest-returning investment in 1974 was gold, in 1902 it was U.S. Treasury bills, and in 1979 it was silver.

The editors then asked how much income a person would have earned at the end of 1999 is he had invested $1 in the highest-returning investment in 1900, and then taken the returns from that investment and invested it in the highest-returning investment in 1901, and so on for each year during the century. After taxes and dealer costs, he would have earned $1.3 quadrillion. (Quadrillion comes after trillion. In 2004, Bill Gates, the richest person in the world at the time, had $47 billion, so $1.3 quadrillion is 27,650 times what Bill Gates has.)

What is the lesson? With perfect foresight (or a crystal ball that always correctly tells you what the highest-returning investment of the year will be), one would be rich beyond his or her imagination.

After the editors ran their experiment, they changed it. They went back and asked themselves what one would have earned over the twentieth century if, instead of investing in the highest-returning investment in a given year, he invested in it one year late. In other words, if X is the best investment in 1956, then invest in it in 1957.

Why did the editors choose to proceed this way? Because they believed that many people only invest in a "hot" investment when it is too late. In other words, they invest in it after they have heard about it, but investing in it after they have heard about it is usually too late. Think of an investment as a mountain. Going up the mountain is comparable to increasing returns on the investment; going down the mountain is comparable to decreasing returns. It's only when the investment is near its peak that many people hear about it. Then it's too late, with no place to go but down.

Here's an example. A person with a crystal ball, or with perfect foresight, would have invested in the Polish stock market in 1993, when no one was talking about it, and reaped a 754 percent gain. The typical investor would have invested in it one year later, in 1994, when everyone was talking about it. The problem is that the Polish stock market fell by 55 percent in 1994.

So, what would the person who is always one year late have earned over the twentieth century? After taxes and dealer costs, $290.

What are the economic lessons here? First, the best investments are often the ones that you don't hear about until it is too late. Second, ignoring the first lesson, and thinking that a popular investment is necessarily a good investment, is often the way to low returns.

Many people seem to think that when it comes to investments, whatever an investment did last year will be what it does this year. If it went up by 30 percent last year, well then it has to go up this year by 30 percent. Consider the words of Warren Buffet, one of the most successful investors of all times: "If past history was all there was to the game, the richest people would be librarians."