Chapter 1

Where Has All the Prosperity Gone?

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If you grew up in the America of the latter part of the twentieth century, you probably formed a reasonable expectation that as you grew up and grew older, your wealth would steadily increase and your standard of living would consistently rise.

It was really more than an expectation. Not quite a guarantee, it nevertheless felt something like a promise—part of a social contract between you and the society in which you lived, a covenant you metaphorically entered into at birth as a citizen of the wealthiest country in the world.

Your part of the covenant was to study hard, get as much education as you could stand and afford, find productive employment, and make your contribution to the gross domestic product (GDP), the nation's overall wealth. In return, you would have sufficient wherewithal not just to live comfortably but to save and invest and assure yourself and your family—possibly even your heirs—a continually escalating

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standard of living. You would invest savings today to have money in the future that you could apply to goals that changed as your life changed: a home of your own, an exciting vacation, a string of college tuition payments, and eventually a secure retirement.

Even though gold watches and comfortable company pensions have been disappearing for years, most commonly you'd look to corporate benefit programs to help with your investing. On-the-job investing typically meant a 401(k) retirement plan, often with matching employer contributions, which allowed you to choose from among a range of investment options, primarily in mutual funds. You might supplement this with your own personal portfolio of investments in equities and fixed-income instruments, and you would probably try to mix up the portfolio in terms of asset class, geography, industry type, and so on as a way of diversifying risk and ensuring reward. Sure, the market value of your account suffered the occasional dip, sometimes a significant one, but over the years, the markets made you more and more prosperous.

And you would likely buy a house. It would probably be your biggest investment, the biggest single asset in your portfolio, the asset you planned to sell when the time came—when the kids were grown and gone and your career was winding down—to fund a secure retirement. Even better, since house prices never seemed to go down, you could spend what you earned—or more—knowing that your house was doing the saving for you.

In fact, owning your own home seemed like something more than just an investment. It, too, felt like part of the covenant. It belonged inherently to the picture we all carried in our heads of the American dream—the career, the house, the expectation of rising prosperity. Compared to your parents, the dream said, your car would be more plush, your house bigger, and your travel more worldly. Maybe your paycheck wouldn't cover this burgeoning lifestyle, but your investment portfolio and your home equity line would cover the gap.

For decades—certainly from the 1980s right through to the end of the twentieth century and just beyond—Americans who held this expectation of rising prosperity were rarely disappointed. The social contract worked; the covenant held. And most of us—again, not unreasonably—began to feel that this was the way things always were and would always be.

And then came the dot-com collapse, the puncturing of the housing bubble, the debacle in the subprime mortgage market, the collapse or near collapse of some of the best-known banks and brokerage houses,

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and then the Great Recession that followed. And the covenant was smashed to smithereens. Even if you dutifully paid your affordable mortgage, kept your debts under control, and followed the textbook solutions for diversifying your portfolio, your fortunes were caught up in the financial storm. Your monthly financial statements told you so. Not only would your investments not pay for life's luxuries; their disappointing returns threatened to deny you the opportunity eventually to stop working, harvest their growth, and enjoy the lengthy retirement you've spent all those hours on the treadmill—both literally and figuratively—staying in shape for. Suddenly the octogenarian greeting you at the Walmart seemed like the ghost of retirements to come.

Crisis

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We all know what happened. We—individuals, families, banks, the government—were leveraged to the hilt with debt that had no real underlying economic value, and when the lenders tested the value of their collateral, there was nothing there. Then as lenders to those lenders began to look more closely at both what they owned themselves and what they suspected their counterparties might own, a very loud financial whistle blew, and the financial system pretty nearly froze in place.

I can give you the date when the crisis began: August 8, 2007. I call it—pardon my French—the "*merde* moment" because that's the day a large French bank realized that it couldn't sell securities it needed to liquidate in order to meet the demand for redemptions from some of its managed accounts. Those accounts held securities tied to U.S. subprime mortgages, and that was the day global markets balked at buying those securities. No market for the securities and hence no redemptions from the accounts meant a liquidity problem for whoever had invested in those accounts. Central banks cranked up the (electronic) printing presses to replace banks' liquidity, but they couldn't hold back the mudslide of asset erosion that followed through the end of the next year from commercial banks, investment banks, and insurance companies that also borrowed and lent.

Moody's Investors Service used to have a plaque over its front door saying, "Credit: Man's Confidence in Man." Once financial institutions lost confidence in each other's balance sheets, credit collapsed, and

with the collapse of credit, there went the ability to finance worthy ventures—as well as those not so worthy. Everything tanked. Banks around the world needed bailouts, stock markets plunged, businesses failed, jobs were lost. In the United States, the financial crisis of 2007 ushered in a seven-percentage-point increase in the unemployment rate, leaving us, as I write this some four and a half years later, with more than 14 million people unemployed. The crisis also sparked a 9 percent decline in the output of goods and services produced by labor and property—our gross domestic product—the largest decline since the end of World War II.

Equity prices fell 56 percent over three and a half years, and your 401(k) became, as one wag put it, your 201(k). Visions of a comfortable retirement turned into plans for keeping the old clunker going long enough to sustain a commute for more years to come—if your job didn't disappear in the meantime.

Housing prices declined by 35 percent, a loss in value you're well aware of if you're a homeowner—that is, if you're a homeowner who hasn't sold short, walked away, or been forced into foreclosure.

Let's hold it right there for a moment, because the housing market was the cause, the effect, and for most people the most painful symptom of our disappearing prosperity. Unless your house is very different from the national average, you probably couldn't sell it now for more than it would have fetched nearly a decade ago. If it's like the average American home, it would now sell for about 30 percent less than its peak value in mid-2006. Even if you had no intention of selling your house, even if you had inherited it at birth and had never spent a penny on it, you still felt the impact of the decline in its value. That's because we found a trick to convert our houses into an income-generating investment without putting it up for sale. Why give up the family castle when you could spend part of its ever-increasing value right now, without the risk of having to pack your mother-in-law's silver or your golf clubs into a moving van?

Enter the magic of the home equity loan. We could spend whatever we earned *and more* as long as house prices kept rising and lenders were willing to advance us the increased value in the guise of home equity loans. It was like having an ATM machine on the bathroom wall. Every day the house was worth more than the day before. So every day our home equity credit lines let us get our hands on that value to keep our lifestyle expanding, regardless of our actual take-home pay. Every day—until one

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fine day when the increased value wasn't there anymore, the ATM machine was empty, and the expanding lifestyle screeched to a halt.

Even though your ATM machine ran dry, the loan that fed it, unless you've already defaulted or paid it off, is still in some financial institution's vault—along with all the other primary and secondary mortgages that were secured by real estate prices that are now a distant memory. Those remaining piles of impaired mortgages leave bankers less willing to lend to one another and less able to lend to the public. The homeowners who still keep those mortgages current can't readily move or refinance or buy many of the goods and services your company or the company you've invested in wants to sell them.

In other words, since the financial crisis of 2007, wealth has been draining from the economy and away from you, and financially speaking, you're stagnant. Even if you've lived within your means, even if you're still able to afford your house or have paid off your mortgage, and even if your stock portfolio is holding its own—no mean feat in a market as volatile and disappointing as this one—it's unlikely that your wealth is growing through these investments. Even the prudent and thrifty among us are disappointed because when everyone else in America lacked the means to consume more and more each year, an engine driving the whole economy sputtered—and investments geared to our domestic growth sputtered with it.

It's equally unlikely that your income is keeping pace with the rising cost of living—exemplified most dramatically by the continually climbing prices for energy and food, two essentials. In fact, between 2000 and 2010, the average American's per capita income, after taxes and adjusted for overall inflation, increased just over $4,000;[1] that's the kind of money that is easily eaten up by higher prices at the grocery store and the pump—not to mention at the doctor's office—all places where prices have gone up more than the headline averages. Having worked for 10 years and found that we have only another $4,000 in purchasing power means that our ability to provide for even modestly expanded needs and aspirations is barely within our reach.

Life feels very much like being on a treadmill: You work and work, you keep on contributing to your retirement plan and feeding your portfolio, you pay your mortgage and your other bills, and still your personal treasury gets no bigger.

Solutions? The ones we used to rely on don't seem to provide the results they once did. The standard diversification fix for volatility in

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financial markets doesn't work when all the financial markets seem to rally or collapse together. However many baskets we put our eggs in, they all seemed to have a hole in the bottom.

You could look for a scapegoat. People doing just that are beating drums a few blocks from my New York financial district office. It's easy to blame Wall Street, banks, and bankers, and the public as a whole has angrily and vociferously done just that, growing especially enraged when we learned that after receiving taxpayer bailouts, individual bankers were continuing to give themselves huge compensation packages. "Compensation for what?" a furious public wanted to know—"Risking our depositor money recklessly with the assurance you wouldn't be the ones to suffer the consequences?" Even the Academy Awards offered an opportunity for a recipient who had written and directed an exposé of Wall Street's sins to call for the jailing of the financial executives responsible.

Political leaders in droves climbed on the bank-bashing bandwagon. Or they spent so much time amping up attacks on each other that they nearly let the country default on its own debt. Or they asserted that the financial stagnation and the smashing of the covenant you relied on were the fault of the government. Taxes are too high, or they're too low, or they're levied on the wrong people. Or blame China. Or globalization. Perhaps. Political debates and government processes are rarely encouraging things to watch—recall Bismarck's famous line that if you want to keep your respect for laws and sausages, avert your eyes from seeing how both are made. But our debate has degenerated into a pitiful spectacle of name-calling and sloganeering. Listening to your favorite finger-wagging pundit on TV may make you feel better, but it won't grow your assets.

Or you could just wait it out. History tells us that it takes about a decade for output, unemployment, and housing values to recover after a financial crisis. That was certainly the case with the housing boom that went bust in the 1980s. Prices dropped consistently for about three years after the bubble burst, but a decade later, houses had recovered all their value, and by about 1998, prices were well beyond their old levels. True, the bubble that followed, the bubble that simply ballooned in the early years of the twenty-first century, was bigger and faster than that 1980s bubble—and its puncturing was correspondingly more explosive. But the weight of history suggests that housing values do reach a point where they really have no place to go but up. Presumably, if you can

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hang on until 2020 or so, all your investment assets will again be on a path of growth.

Or, if you'd rather not wait, there is another way. Invest for the reality of what is—not for what was or what you think ought to be. There is a whole new level of prosperity to be found in what you can't control.

Reality Bites

The reason the old solutions for investment success aren't working today is that they were based on an investing perspective that was inherently specious. The first thing to do, therefore, is to disenthrall yourself from that old perspective. Toss out the covenant. The idea of continually rising prosperity falling into your lap—virtually without your lifting a finger—is gone. In fact, it was a figment of our collective imagination in the first place, and, as it turns out, it was inspired by a fluke. That period of time in which most of us matured financially—specifically, the quarter century between 1982 and 2007—was so special, in an aberrant way, that economists have given it a name. They call it the Great Moderation. Far from being the way things always were and always would be, the Great Moderation was a one-off, an anomaly. To plan for our future, we need to begin by understanding what this anomaly was about and why it had to end.

Market volatility, when it occurred during this period, was modest, and it was brief. It fired up, then faded. The result was what I call the Goldilocks Environment—never too hot, never too cold, always just right for investing. That had not happened before, and it has not happened since.

But it wasn't just lack of volatility that distinguished the Great Moderation; it also represented a stunning respite from the kind of uncertainty that typically prevails in the financial world. While recent television has revived nostalgia for the immediate post–World War II period, the era was actually riddled with financial uncertainty. The man in the gray flannel suit who symbolized the 25-year period between 1948 and 1973 faced a recession every four and a quarter years on average. With unemployment rising to 6 percent five times during the period,[2] he worried frequently about losing his job. When he did enjoy a period of economic growth, it lasted on average only about four years.[3]

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Yet these vagaries of the business cycle seemed tolerable compared to the extended period that followed, when inflation gripped the U.S. economy and stifled its growth. This was an ugly period that whelped an ugly term—stagflation.

Remember the 1970s? Those who do will recall that the price of a loaf of bread cost a nickel more every time you made a trip to the supermarket. Every can of soup had two or three price stickers on top of each other marking successive price increases. Wages continued to ratchet up as well, often driven by cost-of-living pay contracts, but higher wages didn't buy more goods and services. Instead, with wages tied to prices, both rose together, so as the paycheck got bigger, so did the bills for groceries, rent, and clothing. The result was that consumers were no better off while businesses struggled to earn a profit. Our standard of living melted away like your polyester leisure suit when hit by the ashes of whatever you were smoking.

And because businesses failed to grow, the stock market languished. The Dow Jones Industrial Average first broke the 1,000 barrier in late 1972 and reached 1,050 the following January. The index fell below 580 late in 1974 and didn't reach 1,050 again until early 1983: Cash in and cash out, you were back where you had started from 10 years earlier. But a decade of inflation meant that investing $1,050 in 1973 and spending $1,050 in 1983 were two very different things, because by 1983, you needed about $2,355 to buy what $1,050 would have bought in 1973. You would have been better off spending than investing in the Dow. See? Disco music wasn't the only bad thing about the 1970s.

The end of the inflationary plague is legend and reflects the political courage of two Presidents, Jimmy Carter, who in 1979 first appointed Paul Volcker as Federal Reserve chairman, and Ronald Reagan, who reappointed Volcker in 1983. Volcker apparently read the book on monetary policy and recognized that measures like wage and price controls and WIN buttons—for "Whip Inflation Now"—wouldn't stop the price spiral; only a monetary starvation diet for the economy would do the trick. The way central banks like the Federal Reserve cause us to starve for money is to make it really expensive for both individuals and businesses to borrow it.

Under Volcker's leadership, the Federal Reserve pushed the rate at which commercial banks lent money to each other overnight (the Fed funds rate) from 11 percent to 20 percent. Banks depend on this very short-term funding for the cash they need to lend money to you,

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me, and the businesses they deal with. With banks' funding costs this high, the interest rates they charged borrowers also reached daunting levels. Money is like oranges: The more it costs, the less we want of it; and the less money there is circulating through the economy, the less likely it is that the things that require money will happen. Borrowing and lending, buying and selling, expanding and hiring all cratered. With jobs scarce and sales shrinking, businesses couldn't raise prices, and employees couldn't demand wage increases. Inflation began to wither. Two severe recessions later, price stability had returned.

To all of this—the nearly 40 years of volatility, stagflation, and uncertainty—the arrival of the Great Moderation seemed like salve to a wound. Figure 1.1 illustrates how the contrast between that period and the volatile periods of short business cycles, inflation worries, and shaky markets that came before could hardly have been greater, and it shows us what has come since. For the 25 years between 1982 and 2007, inflation ranged between a high of 6 percent and a low of 3 percent. The best stretch came between 1992 and 2005 when inflation never topped 4 percent—and rarely fell below 1.5 percent.

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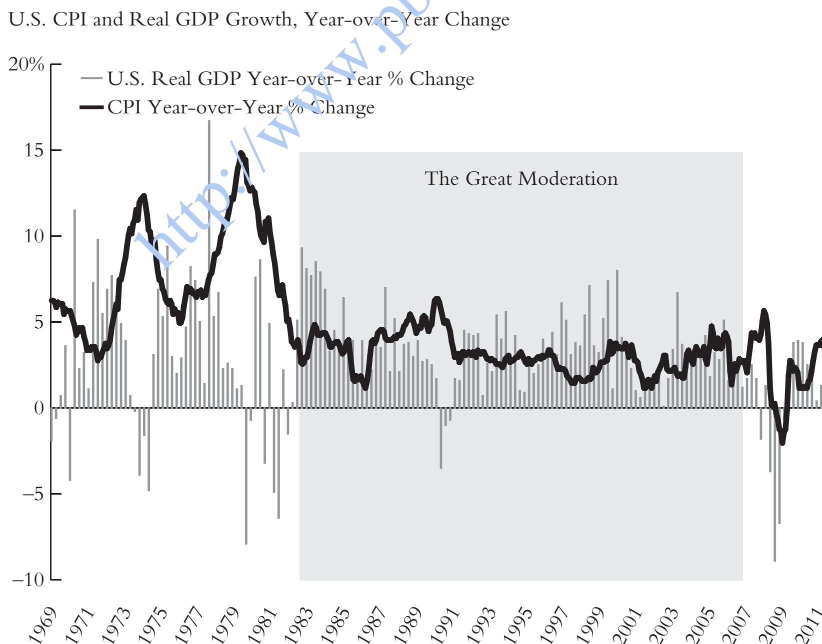

Figure 1.1 The Great Moderation: Economic Growth and Inflation
SOURCE OF CHART DATA: Bloomberg, 2011.

Keeping inflation within that tight and steady range benefited individuals and businesses alike. When you went to buy groceries, clothing, or even a car during those years, you pretty much knew what each item would cost, and if you put off a purchase, you could figure the price wouldn't change that much. And if you operated a business, your wage and inventory costs were stable enough that you could plan for expansions and hire workers without the fear that your costs would soar or that your selling price would collapse.

Yes, we had two brief recessions, one in 1990–1991 following the real estate bubble, oil price spikes, and the first Gulf War, and a second in 2001 following the dot-com bubble. But even during those fairly brief periods when the U.S. economy shrank, the GDP never slipped more than 0.2 percent on an annual basis, which constitutes a pretty small contraction compared to what came before and after. There were only four calendar quarters from the beginning of 1983 to the end of 2007 during which the total value of all the goods and services in the U.S. economy actually declined; in contrast, we saw five between 2007 and the start of 2012.

If those few months when business slowed and jobs were lost could be called adversity, I think most of us would welcome it today. Why? Because the times before and after that so-called adversity brought most of us more economic security than we had ever experienced before or have experienced since. In fact, perhaps the most remarkable thing about the Great Moderation was how long the periods lasted when the economy grew, jobs were plentiful, and businesses could make money. The longest period on record during which the U.S. economy grew without interruption began in March 1991 and lasted for 10 years.[4]

As Figure 1.2 shows, the stock market (represented by the S&P 500 index) was also on a pretty steady run until 2000, tracking right along with home prices. The good times rolled. I splurged on a $12,000 car in 1982. Suppose I'd been content with the average early 1980s ride and spent about half that much[5] and then invested the rest in a way that just kept pace with the Dow Jones Industrial Average. By 2007, I would have been able to sell my stocks and plunk down the money for the BMW roadster that my son-in-law thinks I should be driving.

From 1981 until the tech bubble burst in 2000, the Dow registered just two negative years. Even the crash of 1987 left us with a small gain for the year. In fact, the Dow's average return between 1983 and 2007 was almost 10.7 percent; had you reinvested all your dividends during

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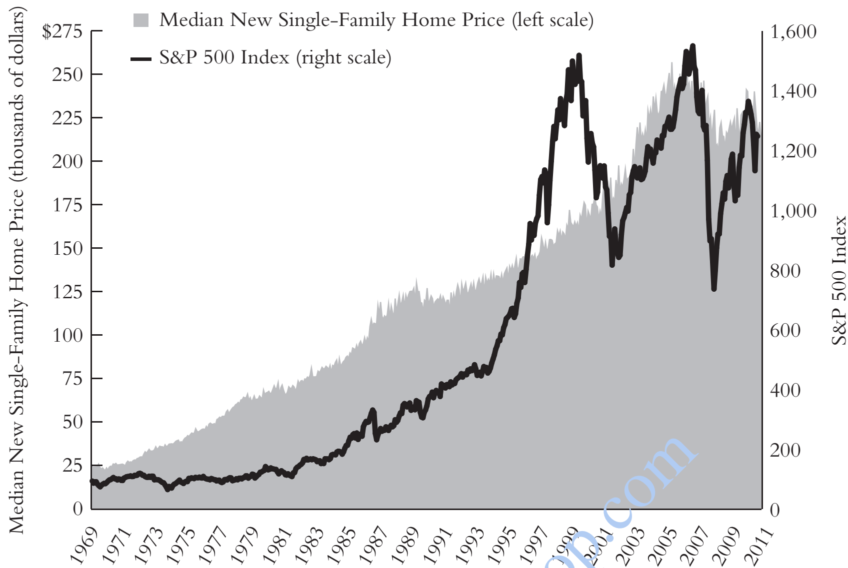

Figure 1.2 The Great Moderation: Equity and Housing Markets
SOURCE OF CHART DATA: Haver Analytics, 2011.

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that period, you would have realized an annual return of a bit more than 13.75 percent—a really good return. The Dow index was at 1,046 at the end of 1982 and had climbed to 13,265 by the end of 2007. And of course the old homestead just kept getting more and more valuable. Ah, for the good old days.

What about inflation? It's true that in 2007, you needed about $2,250 to buy the same goods and services you could have bought for $1,050 in 1982. But if you had invested that $1,050 in 1982 and had earned the return on the Dow, by 2007 you'd have had the purchasing power of about $6,173 in 1982 dollars, both canceling out the inflationary loss and leaving you money to buy a trunkload more of goodies than you could have purchased 25 years earlier. So while I drove my 1982 Olds into the ground, more foresighted folks who had stayed in the market were buying Beemers and Armani suits to wear while driving them. And remember: You made that money just by holding on and ignoring events like the crash of 1987 and the tech wreck of 2000. All you had to do was show up; the stock market rose on its own.

The investment returns of the Great Moderation, especially the continuing boom in the price of our homes, allowed many thrifty, thoughtful people to enjoy a standard of living that their own labor alone

could not have provided—by any definition a very good thing. Those investment gains paid for some folks' fancy cars and designer clothes. They also allowed those of us who had lived paycheck-to-paycheck to borrow against our rising home value and take a vacation, fix up the house, or send our kids to private college. The downside was that the magnitude of the returns and the length of time during which we enjoyed them managed to convince us that such investment returns were normal, to be expected, or even owed to us.

How wrong we were, and no wonder we're angry. Since the economy bottomed out in the spring of 2009, we've had a weak but continuing economic recovery. Overall price inflation hasn't been a problem; in fact, deflation seriously threatened the economy for the first time in over 70 years.

Now look at what's happening in the stock market. In October 2007, the Dow hit its all-time high of 14,164 before closing out the year at 13,264. A little over a year later, in March 2009, it hit a low of 6,547. Since that low, we've had a weak but continuing economic recovery with low overall price inflation, yet despite a solid recovery from that low, you still would have been better off spending your money back in October 2007 than investing it in a way that tracked the returns of the Dow ever since. And you didn't hear it here first. Housing prices are on average down some 30 percent from their peaks. Depending on location, prices may still be declining.

For anyone investing in the market, there's a simple bottom line to all this: The Great Moderation is over. Look back on it with nostalgia as a pleasant peculiarity you were just lucky enough to grab a piece of. Then close your eyes and kiss it good-bye.

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Spell It D-E-B-T

But surely economies rebound. Stock markets recover. The question is when. Two years after the crash of 1987, the Dow was back to its precrash level. Not bad. After it plunged from the high it hit early in 2000, however, it took six and a half years to regain all it had lost. Not so good. Still, one plan of action for investors might well be to just wait, expecting—as I do—that eventually it will again be possible to profit from holding investments akin to the familiar U.S. stock market indexes. That "eventually," however, could be a long time coming.

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Another plan of action, therefore—the one I'll articulate and advocate in this book—recognizes that times have changed and that investment strategies must change as well. No one can promise you how financial markets will behave, and you should ignore anyone who tries, but if we can understand what went right and then went wrong, we can begin to see how the world economy is shifting. Once we get that right, we can begin figuring out how to profit from those shifts.

What has changed? What was so aberrant about the Great Moderation that today we can understand it as an anomaly and be pretty sure that it will not come back—at least not where and how it once resided? What went on in that quarter century that made it so very easy for so very many people to become financially successful in a way that was simply not possible before or since?

The answer is that there was a financial vaccine that kept the Great Moderation going, and now, like an antibiotic up against a resistant strain of bacteria, that vaccine has lost its potency. The vaccine's name? Debt. The doctor administering the vaccine? The Federal Reserve. You can see the pattern in Figure 1.3. Here's the story.

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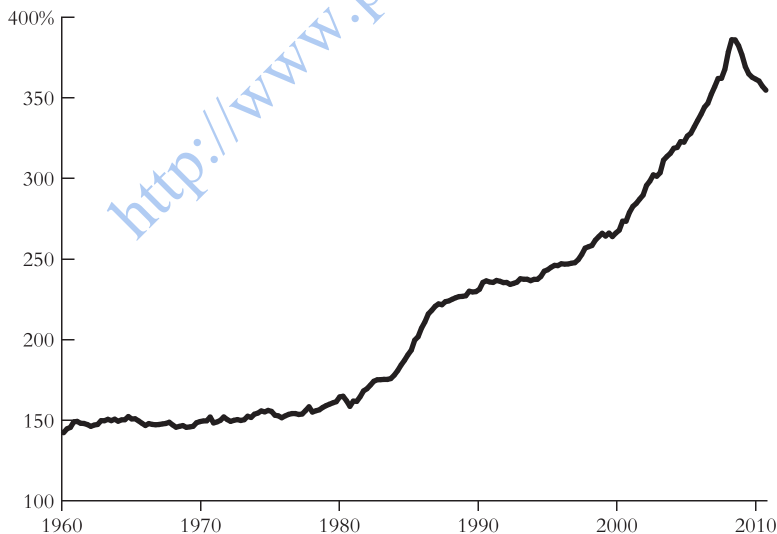

Figure 1.3 The Great Moderation: Debt

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Several historically unique developments came together at one time to bring the Great Moderation into existence and to keep it going for as long as it endured: the baby boom generation maturing from trouble-making youth to productive adulthood, the flow of immigrants with needed capabilities ranging from no-skill laboring power to very high intellectual and technical skills, the advance and proliferation of information and communication technology, and the end of the Cold War. The convergence of these unique developments, like the proverbial perfect storm, produced truly stunning prosperity. Along the way, however, financial crises threatened to bring back the boom-bust cycles of the earlier postwar period or the grinding inflation of the 1970s. At such moments, our Federal Reserve stepped in, tweaking policy time and again to moderate the impact of these crises.

A prime example took place in October 1987. On October 19 of that year, the Dow Jones Industrial Average fell more than 22 percent—a decline only one percentage point less than the combined drop of October 28 and 29 in 1929, the legendary Great Crash leading to the Great Depression. By the end of that October day in 1987, the pundits were forecasting the next Great Depression, and Wall Streeters like me were wondering if we'd all be selling apples on the sidewalk before the week was out. But then a champion stepped forward.

Alan Greenspan had replaced Paul Volcker as chairman of the Federal Reserve in August 1987, an appointment that, as I recall, was greeted with a fair amount of skepticism. Who, after all, could replace the hero of the inflation wars? Critics, however, underestimated Mr. Greenspan because he'd apparently read both chapters of the monetary policy handbook—what to do about inflation and what to do about a financial crisis. In the first major policy test of his chairmanship, Federal Reserve Chairman Alan Greenspan suspended interest rate targets, thus encouraging borrowing, and flooded the financial system with cash. Within two weeks, three-month Treasury yields had fallen by about 2.25 percentage points and 30-year rates were down by 1.15 percentage points. Stock prices rose. Within two years, the Dow had regained its precrash high; the equivalent process after the 1929 crash took more than 25 years. Most importantly, after the Fed's tweaking, the U.S. economy continued to grow for another three years until the oil price shock and Gulf War finally tipped us into recession.

I'm going to tell two jokes in this book. You'll have to read to the end to find the other one, but this one promises to be a real knee-slapper

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because it combines the humorous qualities of the University of Chicago (which undergraduates call "the place where fun went to die") with those of the economics profession, and of course economics is known as "the dismal science." Here is the joke produced by those two comic traditions:

Professor Milton Friedman, the Nobel Prize–winning theorist of monetary economics, is lecturing. He notices a student sleeping in the back row and of course calls on him. The student jerks awake and says, "I didn't hear the question, Mr. Friedman, but the answer is 'control the growth rate of money.'"

Done laughing? Here's what's not funny: Throughout the Great Moderation, the Federal Reserve essentially had the same answer: Control the growth rate (or price) of money, and all will be well.

That was the pattern set from the start of Greenspan's Fed chairmanship. Whatever the real or perceived crisis we faced—recessions and weak recoveries early in the 1990s and the 2000s, the Russian government debt default and a huge hedge fund collapse in the late 1990s, the specter of Y2K, or the reality of 9/11—the Greenspan Fed had a monetary response: It would either lower interest rates or print money, or do both.

Every time it did, a particular market roared. In the late 1980s, it was real estate and junk bonds—high-yield debt to its friends. It was the dot-coms a decade later. And a decade after that, it was housing. You didn't have to hear the question to know the answer, and the Fed got straight A's.

Let's come back to the vaccine that made Fed policy so effective: debt. Behind each of these asset booms was an unprecedented rise in private-sector debt—the money that businesses borrow and the money we borrow on our credit cards, our home equity lines, and our car loans. Sure, with the economy growing and the United States producing more and more, you would expect borrowing to increase along with that growth. If I'm earning more money and adding about the same amount to my debt burden, I still might be okay. But as a country, our indebtedness was growing faster than the speed at which we made more and did more. Just take a look in Figure 1.3, which compares the amount of debt we took on to how much the economy was growing—that is, private debt as a percentage of GDP. During the years following World War II, this important ratio rose steadily in the United States—especially in the years after about 1982, the years of the Great Moderation. When

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growth lagged, the Fed eased the money supply, which in turn made easy credit, which in turn made for market exuberance.

The system worked in reverse as well. If the economy threatened to overheat, to grow too fast and rekindle inflation, the Fed would force up interest rates, making it more difficult and more expensive to borrow. Once things settled down a bit, rates could fall again, and growth would resume its dependable, moderate pace.

Greenspan's ability to use the Federal Reserve's monetary policy powers to conduct the economy's crescendos and diminuendos like an orchestra earned him the sobriquet "Maestro." Speed the economy up or slow it down: The entire strategy depended on credit—on making us more or less willing to borrow and the banks more or less willing to lend. As long as supplying and withholding credit was what drove or slowed the economy, Maestro Greenspan and his successor conductor, Ben Bernanke, could continue to fiddle with monetary policy and control the economy.

But what do monetary policy and the Great Moderation of the economy have to do with our investments? The answer comes back to the basics of risk and return. Suppose I offer you an investment with an expected return of 10 percent a year but, I warn you, with a tendency for its value to bounce around a fair amount. You might be willing to take a risk on it, but you'll probably want to risk a lot less money than if I give you reason to believe that the investment's value will rise that same amount in the future, but smoothly and consistently, without lurching or swaying this way and that. Investors—and therefore markets—like predictability and fear volatility.

Translate that love of predictability to the way stock markets and real estate markets ran up during the past decade, and you'll see why times felt so good. Anytime anyone figures out how to make the future more predictable, investors are happy to put more money at risk. More money means more demand. More demand means higher prices. Higher prices make investors richer, and getting richer encourages them to put more money at risk. And so it goes on and on—as long as somehow we can keep the market from gyrating too wildly.

That's exactly what the Federal Reserve had done, repeatedly and with stunning success, during the Great Moderation: It reduced volatility, seemed to reduce the risk of losing money, and thus reduced investors' fear. Remember the people flipping unbuilt condos in Florida? Their fear was gone—and their judgment with it. So great was the Fed's success in

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doing this that the pundits began to talk about something they called the "Greenspan put." A put is a financial contract that gives the holder of a security the right to sell it to someone else at a prearranged price, usually below the prevailing market price. The owner of the put has to pay that someone else for the option to sell and protect against eventual losses in the market, but having that protection makes the owner more willing to buy the security covered by the put in the first place. Again: less perceived risk, more demand, higher prices, happy investors. Would you be more likely to buy a pair of chic shoes if you knew that someone was contractually obligated to pay you a preset price for your fashion statement even if they pinched too much to be wearable? Yes, of course you would.

In the financial markets you'll pay a price to buy a put, somewhat like an insurance premium, but the Greenspan put the pundits talked about was a gift from the central bank, a sort of gold-plated toaster. It was, in effect, an assurance to investors. The assurance was that the Fed would act as needed to keep markets from gyrating too violently and keep us from losing money. So in a very real sense, we all enjoyed the benefit of the Greenspan put just by waking up each morning.

When the subprime mortgage situation and credit crunch became a crisis in the late summer of 2007 and banks around the world were gyrating so violently they were on the verge of collapse, the Fed and other major central banks knew what to do; they'd heard the joke: Lower interest rates and print money. Invoke the Greenspan put to settle the markets down. And so they did exactly that—lowered interest rates and printed money.

The problem was that it didn't work this time. At first the stock markets' collective knee jerked upward, but within weeks, far from settling down, the markets continued to gyrate—downward. A year after the first Fed easing of the money supply, the Dow was in fact more than 17 percent lower and had much further to fall. Major financial institutions began to fail, some money market funds threatened to return less than $1.00 per share to their investors, and the financial world seemed on the brink of collapse.[6] Financial institutions were unable or unwilling to extend credit; they were too concerned with maintaining sufficient liquidity to keep themselves afloat without taking on the risk of lending to even the more creditworthy of borrowers.

To their credit, the Federal Reserve and other governmental agencies around the world (and across U.S. administrations) recognized that extraordinary steps were needed to avoid complete financial

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collapse and to prop up staggering economies and financial markets. In a very real sense, their actions worked: Many financial markets have stabilized and even rallied. But the ongoing sovereign debt issue in Europe underscores the reach and persistence of the damage done in 2007 and 2008, and it highlights the extent to which uncertainty still reigns. So although the financial markets are partially back, the Great Moderation is not and won't be. The bottom line is that no one can promise you dependable investment returns from the old, familiar strategies you counted on for so long. That's the change in the financial reality, and it's why, if you want to prosper from investing, it's time to move forward.

Now What Will We Do?

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Open your eyes to a new world of investment possibilities. For if you invest in the way the world works—not the way you wish it would work—the winnings can be lush. The opportunity for wealth hasn't gone away; it has simply moved. A seismic shift in the world's economic momentum has transformed the picture of global growth as surely and as dramatically as any collision of tectonic plates transforms the earth's geology. You can't change it; you *can* make money from it.

Figure 1.4 shows the new picture of global growth with recent annualized rates of growth around the world. The contrasts are stark.

The centers of growth and therefore the opportunities for investment are in the emerging economies, the very places that own the headlines today—for good reason. While we in North America, Western Europe, and Japan stumble over inherent impediments to growth that cannot be cured by our usual policy panaceas, the emerging economies possess the natural, institutional, and demographic resources to extend their growth advantage for decades.

One fact alone illustrates the opportunity: Every year, an estimated 120 million to 130 million people in the developing world leave subsistence agriculture behind and become consumers. Put another way, every two and a half years, a number of people equal to the population of the United States starts to produce enough to buy basic consumer goods and services—clothes, shoes, kitchen utensils, MP3 players, laundry detergent, toys for their kids, furniture, haircuts. That's a lot of people and a lot of goods and services. It is an enormous appetite aborning, with

GDP Growth Year-over-Year as of 9/30/11

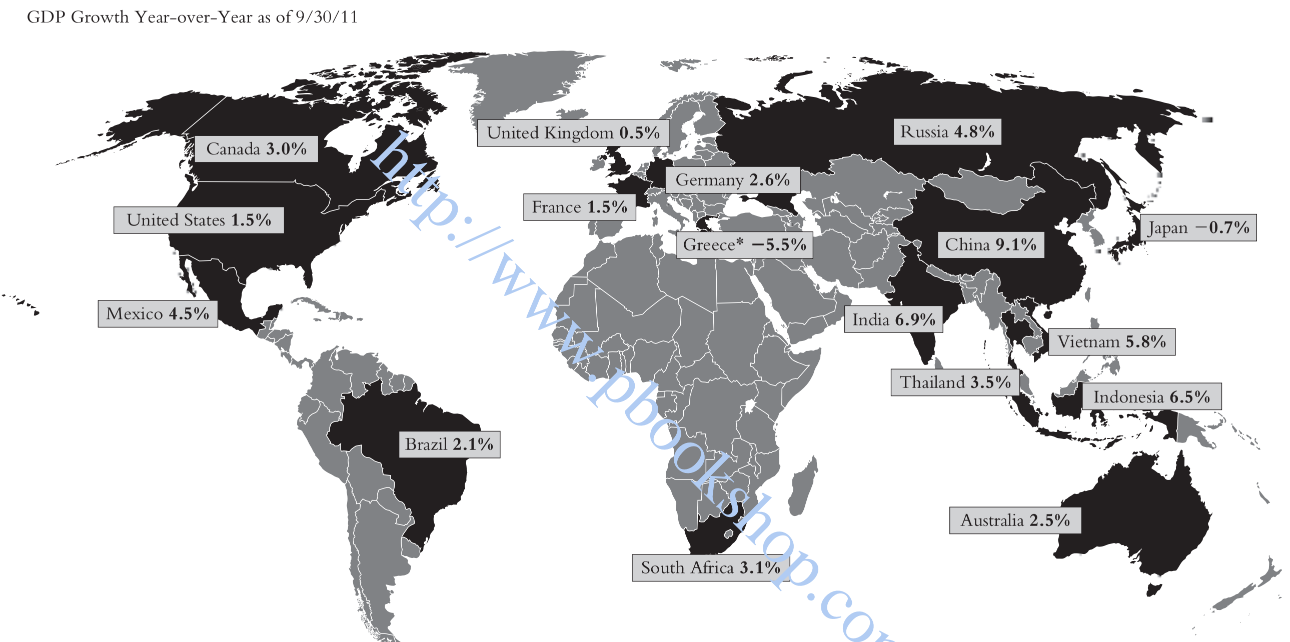

Figure 1.4 The New World of Global Growth

GDP (gross domestic product) is the total value of all final goods and services produced in a country in a given year.

*Greece GDP as of March 31, 2011.

Source of chart data: Bloomberg, September 30, 2011.

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enormous value to be created in feeding that appetite and with a vast demand for the capital to create that value. That is the investment opportunity, and because the appetite is aborning so much faster in these economies than it ever did in ours, now is just the right time to seize the opportunity.

The developed countries still control much of the intellectual and financial capital the emerging world needs. Your own skills and capabilities are part of that intellectual capital. Your savings and investment portfolio are certainly part of the financial capital. This book is about how you can make both grow substantially by investing where the new global potential now is. In other words, right now you're in a position to prosper from what you can't change. This book tells you how.

To start with, here are some caveats, because obviously, to make money by investing in the world as it is, you will need to risk money, and that means you need to take some care. Caveat one: The money you invest should be money you don't need for a while. Caveat two: It should be money you can afford to lose—at least some of it anyway, and at least for some time. Caveat three: You need to be prepared to assume a certain level of risk.

If you can accept these caveats, you're ready. If you can't, read Chapter 8 so you can accumulate the capital you need to get ready. Here's some straight talk, whether you listen to my views or someone else's: Investing, unless you're extraordinarily lucky, cannot absolve you of the need to earn, save, and build a financial safety net before you take significant investment risk. In Chapter 9 I suggest ways in which you might realize some value from that cushion, but you'll need it just the same.

Some years ago, a friend came into a financial windfall (no one died; he sold a book to a publisher). He was always in financial straits, and he asked me how he could invest his advance on royalties to finally get out of money trouble. After explaining that I was legally prohibited from giving him investment advice, I did suggest one surefire method to grow his wealth by about 18 percent a year—a bit less than he'd hoped, but okay. What was that surefire advice? "Pay off every penny of your credit card debt," I told him. End of conversation, but I hope he did it.

Once armed, however, with the savings that allow you to begin increasing your risk and lengthening your horizon, you will be in a position to look for entities that need capital—that is, your investment—to create economic value that will exceed that of your investment. These are likely to be entities with access to a strong or expanding market and

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that produce or provide something that can command a premium in that market. Think of selling a better motorbike to a population that's hurrying to a new job, or cell phones in a place where communications are limited. These businesses should be solid enough not to steal or have stolen from them the value they create. Think of a prestigious brand or a software code that can't easily be broken. And they should be sufficiently in need of capital to offer you an upside good enough to offset the risk you're taking. Once the wall of money has hit the best of investment ideas and pushed its price to fantasy levels, it's time to look elsewhere for another opportunity.

I'll show you where and how to look for these investment opportunities—what to watch for and what to watch out for, how to change your thinking as you put together not just an investment strategy but a comprehensive plan for your financial future.

It won't be as easy as investing used to be during the Great Moderation in which many of us came of age financially. But it offers the opportunity not just to stay ahead of a stagnant economy but to share in the wealth of ascending economies and of growing segments of more developed and familiar markets as well. After all, some of us baby boomers have saved a few bucks or yen or euros and are ready to spend it on our health and leisure. You can make these gains your gain as well, riding our demand for everything from cruises to hearing aids to a higher standard of living for yourself and your family.

The first essential matter is to look at the way the world really works and confront the realities you can't change.

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The Bottom Line

Between 1982 and 2007, the United States benefited from an unusually stable economic and financial environment. We call that unusual period the Great Moderation. It was an anomaly, and it's over.

Among the causes of the Great Moderation, the Federal Reserve's success in conducting monetary policy stands out; remember the Maestro. The Fed's ability to regulate the economy depended on its ability to regulate the rate at which private borrowing increased. The Great Moderation ended in the fall of 2007 when the global financial system could no longer absorb additional U.S. debt. Recession became a prolonged reality; deflation threatened; financial markets gyrated.

The likely impact on you: Your prosperity is probably not growing, despite your having put your money in the surest and safest of investments. Pointing the finger at a scapegoat—or at several scapegoats—will not help you achieve financial prosperity. Blame is not an investment strategy.

What now? We all must adjust our thinking and invest where the financial growth is, not where it used to be. To prosper, we'll all need to understand the potential of geographical places, kinds of markets, and product and service enterprises many of us may find unfamiliar.

This book will help make those opportunities understandable.

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