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## Twelve of the World's Best Investors Reveal the ONE Strategy You Can't Overlook

# Just One Thing

### THE SUMMARY IN BRIEF

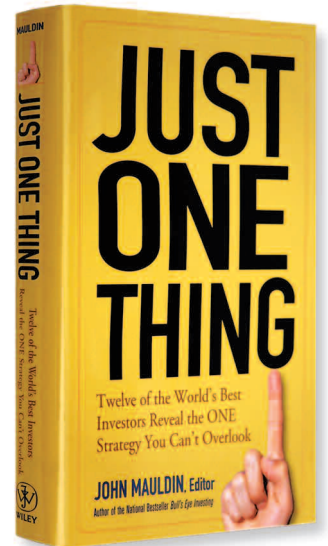
In traveling the shifting terrain of the financial world, one is often met with confusing and even contradictory directions. In the search for a reliable path, there's nothing like a personal guide — one who can show you the most direct route to your goal. In *Just One Thing*, author John Mauldin offers an incomparable shortcut to prosperity: the personal guidance of an outstanding group of recognized financial experts, each offering the single most useful piece of advice garnered from years of investing.

Never before has such an esteemed assembly of financial gurus offered their most valued insights in such a succinct manner. With uncommon clarity, each contributor presents the most precious kernel of advice — just one thing — that he would pass on to his own children and his children's children.

In this summary, these 12 investment gurus share “just one thing” each of them has learned: Rob Arnott, Bill Bonner, Ed Easterling, Mark Finn, Dennis Gartman, George Gilder, Andy Kessler, Michael Masterson, John Mauldin, James Montier, Richard Russell, and A. Gary Shilling. These are practitioners — men who have enjoyed extraordinary success in the market; professional investors who can tell you what works.

### IN THIS SUMMARY, YOU WILL LEARN:

- How to boost returns with “the 2 percent alpha solution.”
- Why you should use “volatility throttling” when assembling your portfolio.
- The secret of “investing in the fog.”
- How to deal with risk when positioning your portfolio.
- How psychology often trumps economics.
- The strength of a nonconsensus investment theme.



edited by John Mauldin

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# THE COMPLETE SUMMARY: JUST ONE THING

edited by John Mauldin

**The editor:** John Mauldin is a leading expert on investment issues. As president of Millennium Wave Investments, he is involved in private money management, financial services, and investments. A prolific author, his books include the bestseller, *Bull's Eye Investing*.

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## Signposts in the Fog

**The Author:** *Andy Kessler was a research analyst and investment banker for some of the biggest firms on Wall Street. He went on to co-found Velocity Capital Management, a hedge fund that turned \$80 million into \$1 billion in five years.*

A stock price is nothing more than the present net value of a company's future earnings. All you need to know is how much a company is earning today, how fast it is growing, and what discount rate to apply to future earnings to get that net present value. Formulas rarely have an input for risk. Even if they did, it's an unquantifiable number. A risk-adjusted growth rate is about as specific as economists can come up with. When a company's stock is out in the open, everybody can see it. Everybody agrees on its prospects. But we don't live in a static world, Kessler writes, so he won't touch a stock whose prospects are in the bright sunshine. "If everybody knows something, you ain't gonna make money on it."

### You Can't Make Money Standing in the Sunshine

Kessler writes that he would rather be out in the fog where nobody knows anything. Then, if he's good, he can peer out into the fog and spot some signposts to show the way to a higher level.

This whole idea of investing in the fog is not about being a contrarian. It's about seeing things before others. Investing in the fog is about seeing things others can't. Most people get in the fog and panic, but the trick is to get in the fog and feel comfortable, let your imagination run wild, imagine what things might look like up ahead, make out vague outlines in the distance, and invest as if those outlines were real things.

Over time, if those outlines become real, or even close to being real, you will have invested at such a discount to the eventual value that you will make a killing. Just don't forget that you are no longer in the fog when you can see what was once an outline and is now living, breathing reality. Get back into the fog. The stock market always looks ahead.

### Pick the Right Signposts

So what are these signposts? Quite simply, they are big trends that you believe in, have confidence in, know in your gut to be true, and have 99.99 percent probability of coming to fruition. These aren't picked randomly or without lots of work, tons of sweat and consternation. Pick the wrong trend and you are following signposts off a cliff.

Here are two real signposts for investing in the fog:

1. Elasticity: lower cost creates its own huge markets. Intel founder Gordon Moore made the observation that chip density doubles every 18 months. Elasticity is just the financial explanation of how the computer industry grows whenever prices of bits or gates or functions drop.

2. Intelligence moves out to the edge of the network. Google is the best example of intelligence at the edge. Google doesn't tell you what you are searching for; it scours the edge of the network for that information and uses an algorithm to calculate if it might be what you are looking for. The intelligence is at the edge vs. the center. ●

## The Triumph of Hope Over Long-Run Experience

**The Authors:** *Mark T. Finn is chairman of Vantage Consulting Group. His son Jonathan is the chief investment*



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service@summary.com

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Rebecca S. Clement, Publisher; Sarah T. Dayton, Senior Editor; Chris Lauer, Senior Contributing Editor; Joanne Merenda, Graphic Designer

officer at Vantage.

Past performance dominates investors' decision processes so much that past performance data may be the most misused information in the investment business. Performance measurement can be useful in understanding the sources of a manager's performance and in comparing a manager to a peer group or benchmark. However, this is a process of explanation of how the manager achieved past success (or lack thereof), not prediction, and is not the same thing as relying on past performance to predict future performance. Unfortunately, in practice, decision-makers overweight historical returns in the decision equation. Sadly, they continue to repeat this mistake time after time, despite bad outcomes. This is called the *triumph of irrational hope over long-run experience*. Past performance may contain some information useful for prediction, but almost certainly not in its raw, reported form.

### Why Do Investors Rely on Past Performance?

Studies have shown that even managers with the best long-term records commonly underperform the market 40 percent of the time, and it is not unusual for them to have periods of three to five years of sub-par performance. Why do investors assume past performance is predictive? A big factor is our lack of appreciation of the level of uncertainty and the central role uncertainty plays in just about everything related to investing.

There is a branch of probability theory that offers some useful insights into how to integrate different sources of information when making predictions. It is called *Bayesian statistics*. In assessing an investment manager's ability (and hence likelihood of producing superior future performance), there are three sources of information:

**1. One's prior belief as to the range of abilities across active managers in general.** What would the range of alphas be so that two-thirds of all managers' alphas will fall within that range? Informal surveys done with groups of professional investment managers showed that they thought the average manager would produce a zero alpha and that two-thirds of all managers would fall within -2 percent to +2 percent alpha, producing total returns within a range of 2 percent below to 2 percent above the market's return for any given period.

**2. One's belief as to a manager's alpha based on an in-depth understanding of the people, process and philosophy employed by that manager.** This source of information is any information about that particular manager independent of historical performance.

### The 'Not-So-Simple' Rules of Trading

Dennis Gartman has been a bank trader, a member of the Chicago Board of Trade, a private investor, and the writer of *The Gartman Letter*, a daily newsletter he's been producing for 20 years. Here are Gartman's "Not-So-Simple" Rules of Trading:

- Never, ever, under any circumstance, add to a losing position ... not EVER! Averaging down into a losing trade is the only thing that will assuredly take you out of the investment business.
- Learn to trade like a mercenary guerrilla. We must learn to fight and invest on the winning side, and we must be willing to change sides immediately when one side has gained the upper hand.
- Capital is in two varieties: mental and real, and, of the two, the mental capital is the most important. Holding on to losing positions costs real capital, but it can exhaust one's mental capital even more seriously, as you become more and more fearful with each passing minute.
- The objective of what we are after is not to buy low and to sell high, but to buy high and to sell higher, or to sell short low and to buy lower.
- Sell markets that show the greatest weakness; buy markets that show the greatest strength.
- In a bull market we can only be long or neutral; in a bear market we can only be bearish or neutral.
- Markets can remain illogical far longer than you or I can remain solvent.
- Trading runs in cycles; some are good, some are bad, and there is nothing we can do about that other than accept it and act accordingly.
- To trade and invest successfully, think like a fundamentalist; trade like a technician.
- Keep your technical systems simple. Simplicity breeds elegance.
- In trading and investing, an understanding of mass psychology is often more important than an understanding of economics.
- Do more of that which is working and do less of that which is not. This is the most important rule of all.

**3. The historical performance record of a manager.** There are a few situations where past performance may be predictive of future performance. These

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situations arise when several criteria are met; the benchmark is a very good representation of all aspects of the manager's style or habitat. However, situations where these criteria hold are quite rare. Indeed, they are so rare that past performance in most cases is useless in predicting future performance.

### Expert Recommendations

Look hard at all risks associated with estimating performance measures, such as information ratios. Bring into the decision equation all the information on the manager's process you can. Factor measurable beta, or risk measurement, out of historical performance, while relentlessly searching for uncorrelated strategies. Use a Bayesian approach. Dampen your enthusiasm and let common sense and experience play an important role in the decision process.

When the time comes to put the portfolio together, weight the allocation to your various managers by the inverse of their variance (or volatility). This is called *volatility throttling*. In other words, take their volatility and weight your allocation to them by the inverse of the volatility (one over their volatility). This means the lower-volatility managers will get more of your portfolio because they probably have less noise — events and factors that are independent of the manager's decisions — in their particular portfolio management style. In essence, this will tend to dampen the noise in your personal portfolio. ●

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## The Long Bond

*The Author:* A. Gary Shilling has been a columnist for *Forbes* for more than 20 years.

Find an important, nonconsensus and long-term investment theme — and stick with it.

To be useful, an investment theme must have the potential to make serious money. It must also be nonconsensus. With today's widespread and instantly available information, the consensus view is fully reflected, or discounted, by security markets. If the vast majority of pundits expects overall corporate earnings to be up 10 percent in a given quarter, stocks won't move much if that forecast does, in fact, turn out to be true. Only a correct forecast of, say, a 20 percent gain adds any value because when it is realized, equities will move appreciably.

An investment theme must also be valid for many years to be highly successful for most investors. A correct forecast of unexpected weakness in payroll employment in a particular month would probably spur Treasury bond

prices, but the gains might erode quickly if the weekly jobless benefit claims in succeeding weeks were well below the consensus forecasts.

### Hang In There

Persistence in the face of occasional adversity and constant disbelief by others makes investment success possible. Keep the big picture in perspective. Don't get carried away with the ongoing chatter on the financial news TV channels or the seemingly important but ephemeral stories in the financial press. Bear in mind that the media offers absolutely no guidance on what's important and what isn't. ●

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## Risk Is Not a Knob

*The Author:* Ed Easterling, president of *Crestmont Holdings*, a Dallas-based investment and research firm, is the author of the book *Unexpected Returns*.

Risk can be friend or foe, and as an investor you will succeed or fail depending on how you deal with it. Risk is an inherent condition of all investments and should be respected, assessed, managed, and prudently controlled. Despite all the ways that risk can be measured and assessed, risk is the likelihood that your investment will lose money.

Higher risks can lead to higher losses unless addressed with the tools of risk management. Risk is not a knob to be turned for greater returns. Turning the knob invites more risk; it does not drive returns. During the past few decades, modern portfolio theories became inverted as investors were led to believe that higher returns necessarily emanate from higher risk. However, risk does not drive returns; returns are what investors seek to compensate for the effects of risk by appropriately pricing the investment.

### Caveat Investor

Determine the risks inherent in potential investments, assess the reward potential, and make rational and prudent decisions. Shy away from unacceptable risks, and position your portfolio to profit consistently.

Whether you take the traditional approach to relative return investing or the progressive approach of skill-based investing, risk is integral to your portfolio. Savvy investors understand the risks and their underlying assumptions and adopt a more businesslike approach to investing, reducing or hedging unwanted or undesirable risks. A well-constructed investment portfolio, like a well-run business, addresses its vulnerabilities and reacts to the ever-changing environment.

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Remember the first principle of Harry Markowitz's Nobel Prize-winning modern portfolio theory: Assumptions are your responsibility. Be sure that your assumptions reasonably and rationally assess risk as you develop, structure and diversify your investment portfolio. Keep in mind that the long-term average is rarely a good assumption.

Risk is an ingredient in every investment, not simply a key to higher returns. ●

### Psychology Matters

*The Author: James Montier is the global equity strategist for Dresdner, Kleinwort Wasserstein based in London, England. He is the author of Behavioural Finance.*

Investing is all about making choices and decisions. Understanding how our brains work is vital to understanding the decisions we make. One of the most exciting developments in cognitive psychology over recent years has been the development of dual process theories of thought. It is a way of saying that we tend to have two different ways of thinking embedded in our minds: One is founded in the emotional part of the brain; the other is logical and deductive in the way it handles information.

Emotion can both help and hinder us. Without emotion, we are unable to sense risk; with emotion, we can't control the fear that risk generates. When we are relaxed and emotion-free, we underestimate how we would act under the influence of emotion.

#### Self-Control Is Like a Muscle

Unfortunately, a vast array of psychological research suggests that our ability to use self-control to force our cognitive process to override our emotional reaction is limited. Each effort of self-control reduces the amount available for subsequent self-control efforts.

One research study found:

**1. Under emotional distress, people shift toward favoring high-risk, high-payoff options, even if these are objectively poor choices.**

**2. When self-esteem is threatened, people become upset and lose their capacity to regulate themselves.**

**3. Self-regulation is required for many forms of self-interest behavior.**

**4. Making choices and decisions depletes this same resource.**

**5. The need to belong is a central feature of**

### Common Investor Biases

Here are 10 biases that have direct implications for investment:

**1. I know better, because I know more.** More information is not better information; it is what you do with it that truly matters.

**2. Big is the same as important.** Investors seem to almost continually overreact to firms with historically high earnings growth, rather than focusing on the likely prospects in the future.

**3. Show me what I want to see.** Investors look for information that confirms what they already believe.

**4. Heads was skill, tails was bad luck.** Investors tend to attribute good outcomes to skill and bad ones to bad luck, making them overlook mistakes they could learn from.

**5. I knew it all along.** After something happens, investors are sure they knew it all along because it is so clear in hindsight.

**6. Irrelevant input has value.** Investors tend to anchor to previous numbers, no matter how irrelevant to the current situation.

**7. I can make a judgment based on what it looks like.** Investors will project high growth for a company that has had high growth in the past.

**8. That's not the way I remember it.** Investors tend to rely on their own experience instead of statistics or experience of others.

**9. If you tell me it is so, it must be true.** Investors believe what they see is what they get with financial information when they should be analyzing it.

**10. A loss isn't a loss until I take it.** Once investors own something they start to place a higher value on it and would rather keep the status quo than give it up, even if there is no intrinsic value.

**human motivation, and when this need is thwarted, the human being ceases to function properly.**

Imagine a fund manager who has just had a noticeable period of underperformance. This manager is likely to feel under pressure to start to focus on high-risk, high-payoff options to make up the performance deficit. He or she is also likely to feel his or her self-esteem is under threat. The fund manager is also likely to begin to become increasingly myopic, focusing more and more on the short term. All of this is likely to be particularly pronounced if the position run resulting in the underperformance is a contrarian one. Effectively, pretty much all the

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elements that lead to the psychology of irrationality are likely to be present in large quantities.

Having an investment process that incorporates best mental practice requires you to step back from the hurly burly of day-to-day market turbulence and understand how to apply psychology's findings to your own behavior. ●

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### The Means Are the Ends

*The Author:* Bill Bonner is the president and CEO of Agora publishing, one of the largest financial newsletter companies.

There are only two ways to get what you want in life: There are honest means and there are dishonest ones. There are economic means and there are political means. There is persuasion ... and there is force. There are civilized ways ... and barbaric ones. When economists endeavor to get people to do what they want — either by offering them money that is not their own, by defrauding them with artificially low interest rates, or by printing up money that is not backed by something of real value (such as gold) — they have moved to political means to accomplish their goals. Every time political means are used, they interfere with the private, civilized economic arrangements that actually get people what they want.

### Mind Your Own Business

You can never know where your actions will lead, or what will happen next in the world around you. What is a person to do? All you can do is become engaged in the struggle for a better world, say the existentialists. Here is other advice: Mind your own business.

In public life, you may be wrong more often than not. If your advice involves forcing someone else to do something ... or deceiving him or her into doing it ... or any other political means of getting what you want, you are almost certainly wrong. You are merely interrupting someone else's private ambitions — and his or her economic means of realizing them. There are no better means for people to get what they want than the economic means — that is, the private, civilized, voluntary arrangements that they work out themselves.

We're not smart enough to know whether one person's plan for world improvement will actually make the place better. All we know is whether the means the person uses are civilized. A businessman can cheat his customers and gain a temporary advantage. So can a great leader invade a neighbor and seem to be on top of the world — for a while. These are solutions to

problems. But in both cases, resorting to political means to achieve the ends they craved took them over to the dark side of life. They are no longer doing civilized things, but barbaric ones.

The ends are beyond us: We never know what will happen. All we have is the means. That is all we control. But if we use the means of civilized people — the economic means — to get what we want, we will not necessarily get what we want, but at least we will deserve it. ●

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### The 2 Percent Solution

*The Author:* Rob Arnott is chairman of Research Affiliates, runs an \$8 billion fund for Pimco, manages a few hedge funds, and is also the editor of the *Financial Analysts Journal*.

We can improve on capitalization-weighted indexes like the S&P 500. Any index that is replicable, objective, transparent, and focused on large and liquid companies, which are easily traded, is a potentially useful index. Any such index that is valuation-indifferent should beat the capitalization-weighted stock market. If we don't care what price to earnings ratios are or what the price is when setting how large our investment in an asset should be, we should beat cap weighting in the long run.

What could we do to accomplish this goal? We could find the thousand largest companies by book value, and create an index weighted by book value. In this fashion, we pay no regard to the price or the market capitalization, simply indexing by book value.

You can do anything of this sort, anything that captures the scale of a company, so you have a bias toward large and liquid companies that is replicable and objective but that doesn't pay attention to valuation.

### Indexing Works

Fundamental indexing works especially well in an environment of recession or a bear market or rising rates. But it also adds modest value in the more benign environments, with economic expansion, falling interest rates, and a bull market in stocks. Value investing generally does not add value during expansions, bull markets, or periods of rising rates.

Is it an index? Of course it can be an index. Is it passive? Yes: It's replicable, formulaic, transparent, and objectively constructed. Is it a total market portfolio? Not in a capital asset pricing model context, because it doesn't span all marketable assets equivalent to their weight in the actual market. But no index fits this criterion.

Are the cap-weighted indexes efficient? That is to say, can you improve them by constructing better indexes,

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without taking on more risk? Yes, you can improve upon them, so the cap-weighted indexes are not efficient. The classic indexes are actually not the market, and no commercially viable marker portfolio exists; and even if one did it wouldn't matter, because the capital-asset pricing model is predicated on so many structurally flawed assumptions that the notion that the cap-weighted indexes must be efficient is the same as the notion that the underlying assumptions must be true.

### Real Implications

There are very real implications in this model for long-short investing. Large institutions and pension plans will probably move large portions of their equity assets into indexes like this. What is a 2 percent difference worth? Let's assume that, with your current portfolio, in 36 years you end up with \$1 billion. If you can increase portfolio performance by just 2 percent, you will end up with \$2 billion. A 2 percent alpha doubles your cumulative assets over these longer time horizons of pensions.

If you are an individual, the same principle applies. Over 36 years, that 2 percent will double your return. ●

## The Outsider Trading Scandal

*The Author:* George Gilder is editor of the *Gilder Technology Report*; chairman of *Gilder Publishing, LLC*; and a senior fellow at the *Discovery Institute*.

The law for information disclosure by public companies and aspirant public companies prohibits the release of materially significant news unless it is published simultaneously to the world. This well-meaning rule is sup-

posed to create a level playing field where no investors have the advantage of inside knowledge. But a level playing field means no information, which is defined as a deformation of the level. Information, like life, is disequilibrium. What the Securities and Exchange Commission accomplishes is to reduce the amount of real information in stock prices.

Less information means increased volatility and more vulnerability to outside events. With the entire field of information about companies a regulated arena, information does not bubble up from firms spontaneously in raw and ambiguous form with executives and engineers freely expressing their views and even investing on the basis of them. It emerges as various forms of processed public relations.

### The Investor's Challenge

The key for investors is to ignore the outside noise and focus on acquiring real, fundamental knowledge about companies. The fundamentals will ultimately prevail. Inside knowledge is harder to get under the new regime, but it remains irrepressible.

The Internet is full of sources of competitive analysis and technological expertise. New companies are emerging with powerful ways of obtaining and revealing the crucial troves of inside knowledge that determine the destiny of companies. Some of this information is being made available to the public by vendors such as Gerson-Lehrman with software that enables quick links from investors to hundreds of thousands of available experts. A new generation of information companies, focused on the real sources of value in markets, is creating a new topology of information amid the leveled playing fields of government-enforced ignorance. Watch for these developments and take heed. Skill and information are your remedies for the dismal economics of gamblers' ruin. ●

## The Winner's Rule

Successful businessman Michael Masterson writes that there is a way of conducting yourself in business (and other areas of your life) that can give you success, peace of mind, and happiness.

That secret is this: In every relationship you get into — every business, social or personal transaction — make sure that the other person gets as much benefit from it as you do. When considering your own advantages and disadvantages in taking any course of action, consider those of everyone else involved.

Thinking about the other guy first may not be instinctual behavior. But the course of human progress could be said to be the history of our efforts to do just that.

## Rich Man, Poor Man

*The Author:* Richard Russell has been writing and publishing the *Dow Theory Letters* since 1958.

Making money entails much more than predicting which way the stock or bond markets are heading or trying to figure which stock or fund will double over the next few years. For the great majority of investors, making money requires a plan, self-discipline and desire.

The average investor needs to have a financial plan. Here are some rules on investing that should be followed if you are serious about wanting to make money:

### Good Advice About the World of Wealth

Michael Masterson offers these pieces of advice:

- Business doesn't happen until you make the first sale.
- The single most effective way of entering a new market is to offer a popular product at a drastically reduced price.
- It's ultimately about selling. Great businesspeople make their fortunes by increasing the perceived value of their products, thus ramping up prices and drastically increasing profit margins.
- When choosing a business, select one that can be grown without your personal involvement. In growing your business, make sure it can expand with the addition of more money, property or people — but not more of you.
- Before you invest in anything, know exactly how much you are willing to lose — and get out if you hit that stop-loss point.
- First improve your strengths. Then, eliminate your weaknesses.
- Focused effort is more effective than a diversified approach to business building.
- Let your winners run and cut your losses short. When the marketplace tells you that your great idea is a loser, don't keep pushing.
- Pareto's Principle (the 80-20 Rule): 80 percent of your success comes from 20 percent of your resources. Most of the success, income and satisfaction you will get in your career will come from a small portion of your skills, projects and efforts.

**1. Compounding works.** To compound successfully, you need perseverance in order to keep you firmly on the savings path. You need intelligence in order to understand what you are doing and why. You need knowledge of the mathematical tables in order to comprehend the rewards. You need time to allow the power of compounding to work for you.

**2. Don't lose money.** Most people lose money due to disastrous investments, gambling, rotten business deals, greed, and poor timing.

**3. Wealthy people don't need the markets.** They already have all the income they need. Money is being generated from bonds, T-bills, money-market funds, stocks, and real estate. They never feel pressured to “make

money” in the market.

**4. Look for values.** The only time the average investor should stray outside the basic compounding system is when a given market offers outstanding value. This means it offers safety, an attractive return, and a good chance of appreciating in price.

All investing and speculation is basically an exercise in attempting to beat time. Time is the single most valuable asset you can ever have in your investment arsenal.

There is no substitute for acting. In the business of investing or the business of life, thinking is not going to do it for you. Thinking is just rehearsing. You must learn to act. The reasons to act are almost always better than the reasons you can think up not to act. ●

### The Millennium Wave

*The Author:* John Mauldin is a leading expert on investment issues.

We are only halfway through what we call the Information Age, with more profound changes as to how we work and play just around the corner. But this time something is different. Instead of one wave of innovation following another, we are going to see multiple waves of significant change and innovation surge all over the world at roughly the same time. The combined effects are going to produce a period of change unlike anything seen in the history of man. This Millennium Wave will change things in ways that almost defy the imagination and at a pace that will leave one breathless.

Looking at which things will not change will give us some clues as to what will change. There are three things that over the next 40 years are not going to change: the innovation cycle, the business cycle, and human psychology.

### Surfing the Millennium Wave

The more precisely you plan your future, the harder that change will hit you. Flexibility will be the order of the day.

The Millennium Wave is also going to offer the greatest investment opportunities ever seen, as whole new companies and processes are created. Taking advantage of all these changes will require nimbleness and an ability to make decisions, rather than passively investing in indexes, which will reflect the companies that have already become large or are ready to go the way of the dinosaurs.

Change. You'd better get to know and love it. It is coming. That is one thing that for certain will not change. ●