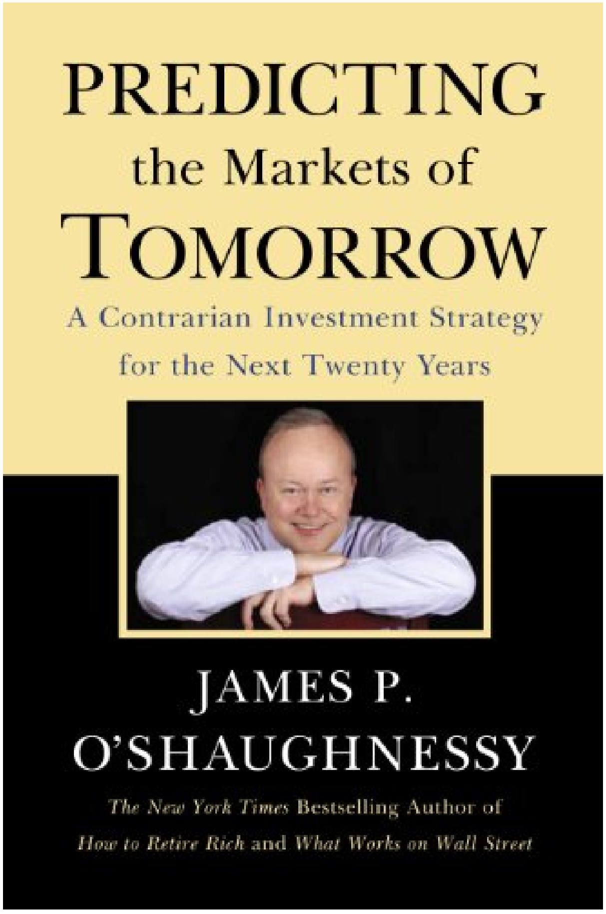
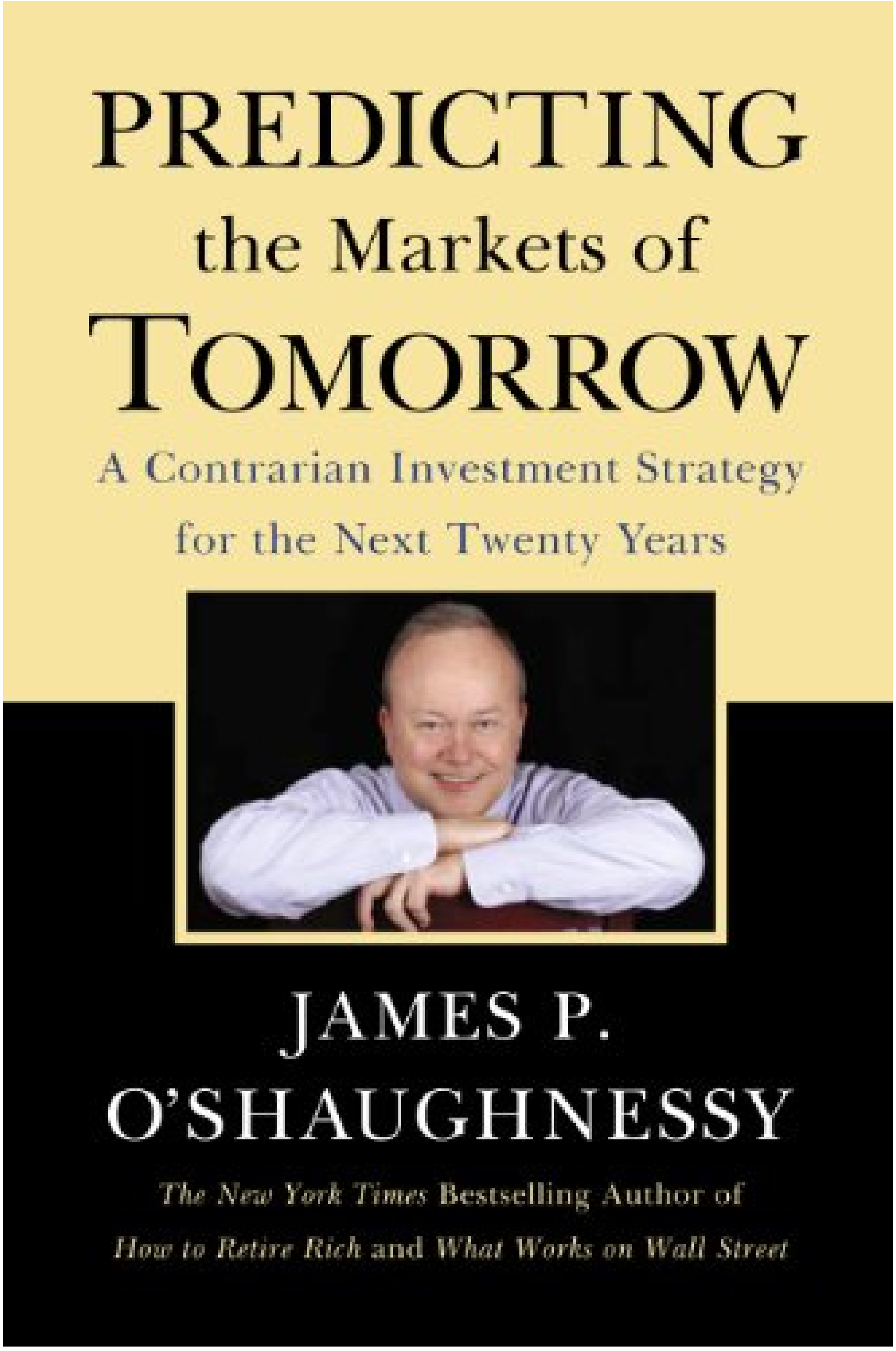
PREDICTING THE MARKETS OF TOMORROW: A CONTRARIAN INVESTMENT STRATEGY FOR THE NEXT TWENTY YEARS BY JAMES P. O'SHAUGHNESSY




PREDICTING
the Markets of
TOMORROW
A Contrarian Investment Strategy
for the Next Twenty Years
JAMES P.
O'SHAUGHNESSY
The New York Times Bestselling Author of
How to Retire Rich and What Works on Wall Street

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From Publishers Weekly
A Bear Stearns executive and bestselling financial adviser, O'Shaughnessy (How to Retire Rich) is a self-described "passionate advocate" of paying attention to the stock market's historical trends rather than impulsively reacting to short-term fluctuations. Though the technology bubble of the '90s led many to believe the financial rules had changed, O'Shaughnessy still believes that the soundest investment lies not in chasing the fastest-growing big stocks, but in careful management of holdings in small and midsize companies, with large companies selected for value rather than expansion. Buttressed by an array of financial charts, he discusses how to create a set of investment portfolios—some with as many as 25 separate stocks—that with annual tinkering will yield effective results over a two-decade period. His advice tends toward technical precision; when discussing intermediate bonds, for example, he recommends a laddered portfolio that continually frees up assets for potential reinvestment in the event of changing interest rates. Although he speaks briefly to the emotional reasons why most investors are unable to resist the allure of short-term gains, O'Shaughnessy is primarily concerned with the cold, hard facts that will trump sentiment, and he lays out his positions in a straightforward and effective manner. (Mar. 2.)

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About the Author
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A unique and timely new wealth-building strategy from a legendary investment guru

In his national bestsellers How to Retire Rich and What Works on Wall Street, portfolio manager extraordinaire James P. O'Shaughnessy offered investors practical advice based on rigorous quantitative analysis—advice that has consistently beaten the market.

But in a recent analysis of market data, O'Shaughnessy uncovered some astonishing trends not discussed in his previous books. The Markets of Tomorrow explains O'Shaughnessy's new research and tells ordinary investors what they must do now to revamp their portfolios.

According to O'Shaughnessy, the year 2000 marked the end of a twenty-year cycle that was dominated by the stocks of larger, fastergrowing companies like those in the S&P 500. In the new cycle, the stocks of small and midsize companies are the ones that will outperform the market, along with large company value stocks and intermediate term bonds. O'Shaughnessy describes the number crunching behind his analysis and then shows individual investors exactly how to select the right mix of investments and pick top-performing small and midcap stocks.

The Markets of Tomorrow is a loud and clear call to action for every investor who doesn't want to be left behind.

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33 of 34 people found the following review helpful.
Reversion to the Mean
By Leonard J. Wilson
In Predicting the Markets of Tomorrow author James O'Shaughnessy offers his ideas on the investment environment we are likely to encounter over the 20 years from 2006 through 2026. He selected twenty years as this time horizon based on extensive analysis of market behavior over approximately the last 200 years. His logic goes something like this:

1. When calculating returns from any investment strategy, it is essential to focus on the real return, after accounting for inflation.

2. Approximately two hundred years of stock market data (1809-2004) show that real returns have been highly erratic, especially when analyzed over periods of a few years or less.

3. However, when one calculates returns using overlapping periods of 20 years, they become much smoother. Stocks have rarely lost value over a 20 year period.

4. There are probably some underlying factors that cause returns to be smoother over 20 years. O'Shaughnessy suggests two. First, many investors don't really get started saving and investing until their mid 40s, giving than about 20 years to accumulate assets before retiring. Second, retirement at 65 together with a life expectancy of 85 suggests retirements (and asset depletion cycles) that last about 20 years.

5. If one decomposes the 20 year average returns of the S&P into the returns of the growth and the value stocks that comprise the S&P, these two groups have tended to move out of cycle with each other. Growth stocks occasionally have produced the higher return, as they did in the 1980s and 1990s. More often, value stocks have outperformed value stocks.

6. The returns of these three groups (S&P, Growth, and Value) all seem to revert to their mean rates of return. Any group that has outperformed in a 20 year interval is likely to underperform in the next 20 year period.

7. Since growth stocks outperformed in the 1980s and 90s, it's now their turn to underperform while value stocks outperform.

8. One can also segment the market by the capitalization (the total value of all the shares of a company). This analysis suggests that small cap stocks are likely to outperform large cap stocks over the next 20 years.

9. The average 20 year real returns /standard deviations of the key market groups between 1947 and 2004 have been:

Large Cap Growth: 6.26% / 3.83%

S&P 500: 7.30% / 3.76%

Large Cap Value: 10.32% / 3.42%

Small Cap: 10.42% / 2.94%

10. As seen in the figures above, Large Cap Value and Small Cap stocks have higher returns with lower standard deviations. When you add on the fact that these two groups have underperformed over the last 20 years, O'Shaughnessy appears to have a compelling argument for focusing on these two groups. To hedge his bets slightly, he recommends a preferred portfolio allocation of 50% large cap value, 35% small cap growth, and 15% large cap growth.

11. Fixed income securities, even inflation protected treasuries (TIPS) are currently producing returns that, at best, break even. They are "Return-free risks, not risk-free returns". Avoid them except as a place to park cash they you will need in the next few years.

Reviewer's Comments: I agree with O'Shaughnessy's approach and conclusions but would have liked a better justification for using 20 year average returns. One could argue that generations are separated by about 25 years which might make that figure the logical interval for averaging. Perhaps someone has (or should) compare the results of averaging over different periods such as 10, 15, 20, 25 and 30 years. Or, even better, use a Fast Fourier Transform to determine the power spectral density of each time series.

2 of 4 people found the following review helpful.
I admit it -- I'm a geek
By Noah Gibbs
I love having numbers to back things up. I do. O'Shaugnessy delivers in spades. His opinions include some guesswork, but also thousands and thousands of checked inflation-adjusted returns from decades of the stock market, graphed nicely, so I can check his work and come to my own conclusions. I can imagine no better book on technical investing for me.

He also has good quick summaries of his findings at the end of each chapter and in the introduction, for the rest of you :-)

27 of 35 people found the following review helpful.
Excellent and clear research
By E. Chan
I have read many investment books -- this is one of the best. It offers clear guidance and solid research to back up the predictions and claims. The claim that small-cap value stocks will outperform all the rest is backed by careful historical analysis and testing. I especially like the fact that the research done is for an

appropriate time frame for those of us worried about retirement -- 20 years, and that "real returns" -- inflation-adjusted returns -- are used, instead of nominal returns that are most often cited by books and websites. The only hesitation I have in following the advice in this book is to invest in 10 large cap value stocks -- one of them, like GM, can easily go bankrupt and wipe out 10% of the portfolio value. I personally would stick to ETF, unless I have enough capital to hold at least 25 stocks in my portfolio. All in all, good, clear, and simple investment advice with serious research.

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