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Everything You Need to Know About Investing

By Michael S. Falk, CFA®, CRC

INVESTMENTS & WEALTH INSTITUTE®

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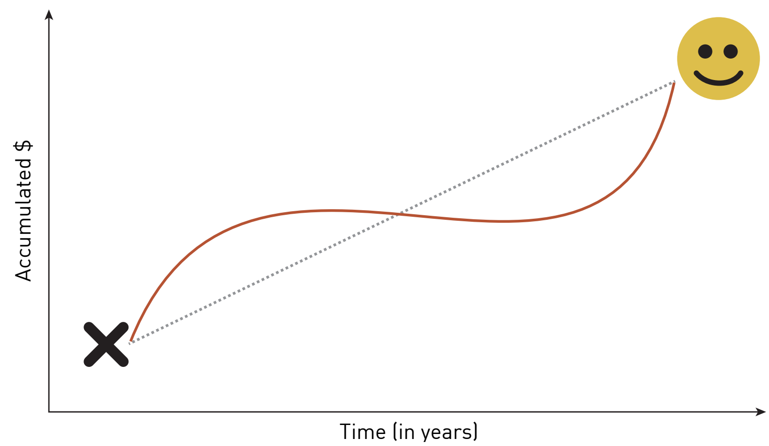
The act of investing almost always has a purpose, a goal.[1] However, all too often, investors fail to do what's necessary to increase the probability of reaching their goals. The causes range from too little investment literacy to disadvantaged (emotionally biased) decision-making to poor planning.[2] Vast resources are available to help, but numerous hurdles stand in the way of that help. The abundance of resources causes confusion and worry about which to trust. Written resources may not be read, understood, or retained, and trained resources possess the very same decision-making challenges that average investors have.

Average investors, as well as those from Lake Wobegon,[3] need a simple, effective guide that can help them understand how their goals, the path toward those goals, and the choices they make along the way help or hinder the probability of success. Decisions about investments, what to invest in, pale in comparison.

To that end, this article uses variations on a basic graphic to help make sense of investment planning and the choices that invariably arrive over time (see figure 1).

Figure 1 WHERE YOU ARE AND WHERE YOU WANT TO WANT TO BE



THE GOAL IS SIMPLICITY

I have dared to produce an easy-to-understand guide that could be the only investment guide you may ever need as you pursue your financial goals. In short, your path-dependent decision-making is more important than your investments,[4] and investors with better behavior (behavior > investments) can be more successful.

Why is simplicity the goal? The answer is simple: Most people can execute simple. Complexity is too often misused by people trying to win at others' expense.

X marks the spot. "You are here" based on your current savings and investments. This investor is cash-flow positive; if cash flow is negative (i.e., x falls below zero on the y-axis), the slope of the dotted line becomes steeper and it's harder to reach goals. Being cash-flow negative is a slippery slope that requires a short-term focus versus long-term planning—you need to stop taking on debt and start building savings so life's curveballs can't strike you out.

The happy emoji is your goal. This is your "funded contentment," aka your financial goal(s) in the future. Goals further in the future are easier to achieve; those that are very soon are more difficult. Unless you can act unilaterally, your vision of success must be aligned with that of others, be it a significant other or an investment committee. Defining this as dollars desired in the future—because it's in the future—must be considered art based on today's cost and assumed inflation rate. Updating a goal's estimated cost over time is important, particularly for more distant goals.

The dotted line is the mathematical path to satisfy your goal. It represents the target return needed to reach funded contentment given your current and forecasted savings. This target return may or may not be available at any given time, but it is your calculated path. It hides the real-life ups and downs of investments, and it shows where you are progressing relative to the path to your goals. As a helpful exercise, assume a very conservative, low return such as 2 percent, which increases the amount you need to save to reach your goal. If you cannot save that much, or delay your goal, then you need to invest more aggressively.

The curvy path is your actual route. It represents the wandering route taken by your savings via your investment results. Sometimes the market giveth and other times it taketh away. Think of Benjamin Graham's market personification "Mr. Market" and his bipolar mood swings, which are random and can be significant. For example, Mr. Market may become depressed after you've spent a lifetime saving and investing, taking a big bite out of your efforts. But if Mr. Market is depressed when you begin saving and investing, and then turns manic shortly before your goal, it could be a huge bonus for your nest egg. The "sequence"—the timing of good or bad investment returns—matters, and it could matter a lot. The magnitudes of Mr. Market's mood swings also matter because they tend to affect investors' moods. Diversification is a medication that helps lessen such mood swings.[5]

A BRIEF DETOUR OFF OUR PATH TO DEFINE RISK

Two terms—conservative and aggressive—need to be better defined because the terms themselves can mean different things to different people. Clarity is critical.

The formal definition of risk is that more things can happen than will happen. I prefer, however, to classify conservative and aggressive in terms of predictability, because having fewer things that can happen helps our aversion to uncertainty[6] and the biased decision-making that results. The more predictable an outcome, the easier it is for us to make a bet and, more importantly, stick with that bet, too.[7] Let's classify that bet as being conservative. Of course, the opposite holds for aggressive. Maybe even consider the allocation boundaries (limits) of a low of 30 percent and a high of 85 percent in stocks.

Here's an approach to understanding risk in the stock and bond asset classes. To define predictability, I suggest we use two parameters: the narrowness of the asset class's distribution across past calendar-year returns (e.g., five- and 15-year perspectives) and the number of outliers.

Conservative investments are defined as those that have narrower asset class distributions and fewer outliers. Of course, the opposite holds for aggressive investments.

For example, we could calculate the 30th percentile minus the 70th percentile performances within the asset class (the percentage returns) divided by the number of calendar-year[8] results (the number of outliers, e.g., 11) outside of those percentiles within the asset class. Smaller results are more conservative than larger results. Bonds are most often more predictable than stocks and, for our purposes, more conservative. Because this article only considers index funds, no more clarity is needed.

Thinking in terms of predictability is helpful because achieving our financial goals takes planning and good decision-making versus rolling dice and hoping for the best. Therefore, the only useful definition of risk is the probability of falling short of one's financial goal(s).

THE BIPOLAR MARKET

Because none of us chooses which market we get born into, or what kind of mood Mr. Market may be in, figure 2 adds a couple points of significance.

Figure 2

IMPACT OF A BIPOLAR MARKET ON THE INVESTOR'S PATH

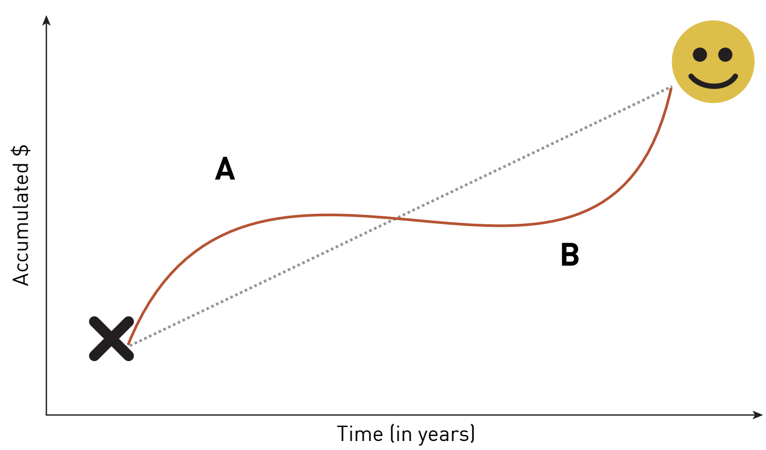


Figure 3

A MANIC MARKET MAKES THE TARGET RETURN EASIER TO ACHIEVE

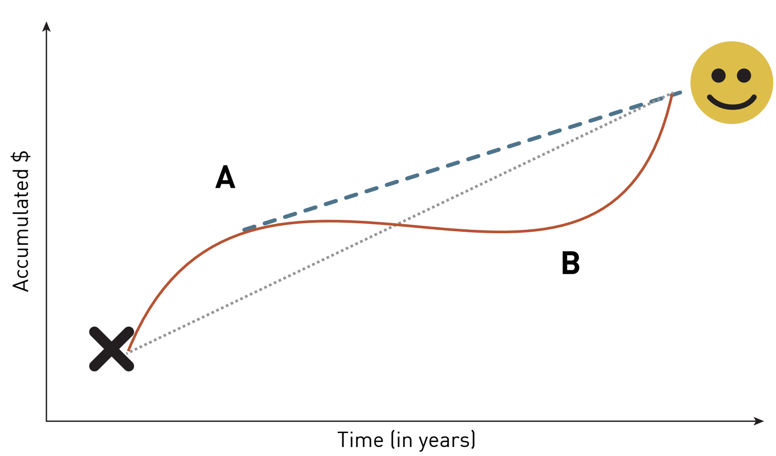
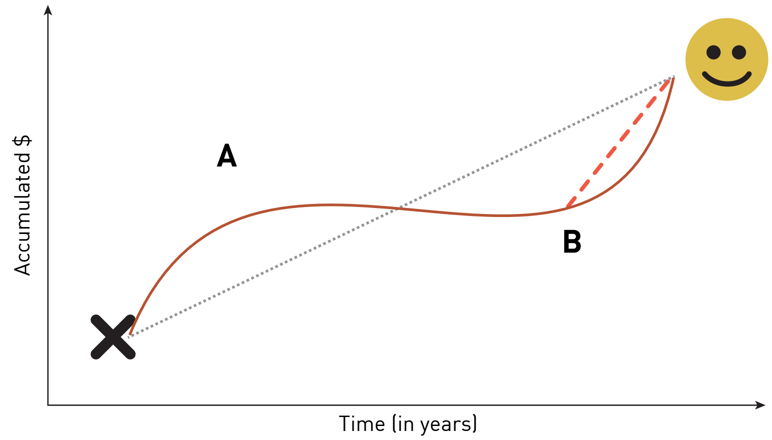


Figure 4

A DEPRESSED MARKET MAKES THE TARGET RETURN HARDER TO ACHIEVE



Path A occurs when the market is amiable or manic; path B occurs when it is depressed.

FIRST, A POSSIBLY MANIC MARKET

After a winning period of investment returns (i.e., the market has been at least pleasant or even manic), your new locale is labeled as A in figure 2. From A, you face new choices and trade-offs. The good news is that your target return has decreased; i.e., the dotted line has a flatter slope and an easier climb compared with the target return line, as shown in figure 3.

Your options are described below:

You could choose to begin to save less. If paying your bills is stressing you out, maybe you can benefit from saving less and increasing your cash flow. But, if your financial life seems easy, maybe you should continue saving according to plan. After all, what's the worst that could happen—you succeed sooner, or you have a cushion if and when your good fortune turns? If you're spending to keep up with the Joneses, you could decrease your savings so you can consume more and keep living on the hedonic[9] treadmill, but consider that your path to contentment may no longer have a finish line.

You could choose to begin to invest more conservatively. Do you wish to reduce (sell down) your investments in stocks, for example, because they have grown a lot relative to your other investments? This is called rebalancing. If you considered your risk preferences and needs originally, then your current investments no longer may meet those objectives. You may wish to reset to your attained progress and reassess which investments best meet your objectives. This is investment planning. Gambling could look more like letting it ride to maybe achieve your funded contentment earlier or up-sized. But, of course, you also could give back your attained progress if you don't take some of your winnings off the table. If this good fortune is nearer (in time) to your financial goal, playing it safe is an easier, wiser option.

You could do nothing. One paradox of choice is that as decisions grow more complex, they also become less gratifying.[10] When faced with difficult choices, we're prone to decision traps, such as regret bias, which can paralyze decision-makers. By not deciding, you decide to do nothing—which is an admission that you lack confidence in any of the other choices. Beware also of activity bias, as well as overconfidence. Activity bias prompts us to do something (anything), and overconfidence supports that decision regardless of whether it is the right choice. Also consider that when we are "ahead," let's reflect on Nobel Laureate Daniel Kahneman's prospect theory, which showed how we tend to be risk-averse with gains (versus risk-seeking with losses) and may be biased toward a rebalancing activity.

You also could combine choices by altering your savings and your investment risk. Note that combinations could be multiplicative (less savings/less investment risk or more savings/more investment risk) or could offset each other (more savings/less investment risk or less savings/more investment risk). The results of combinations can and should be estimated, just as you computed your target return, before embarking on such a decision.

THEN, A POTENTIALLY DEPRESSED MARKET

After a losing period with your investments, your new locale is B in figure 4, and the slope of your new target return line is much steeper. You have the following choices:

You could choose to begin to save more. This works if you are able and willing to reduce your spending. Could you? Would you? Keeping your eye on the prize can be tough; spending on even little creature comforts today may seem insignificant, but they can add up and derail your financial goals.

You could choose to begin to invest more aggressively. You could increase the amount you invest in stocks, for example, but only if this fits within your risk preferences and ability to cope with Mr. Market's mood swings. Can you cope? How are you coping right now? Selling stocks in a depressed time can be among the most damaging decisions you can make.[11] And, if you already were invested more aggressively, you might not even be able to make this choice easily without rolling the dice on your financial goals.

You could do nothing. Recall the decision traps discussed above. Given that investment losses are uncomfortable, people often want to do something that fits with the other part of Daniel

Kahneman's prospect theory, which describes how people are risk-seeking with losses. Instead of reacting, reassess your financial goals. Might those goals be acceptable a year or two further into the future or in reduced terms? If your goals can be pushed further into the future, you may not need to do anything.

You also could combine choices by altering your savings and your investment risk. Note that combinations could be multiplicative or could cancel each other out. The results of combinations can and should be estimated, just as you computed your target return, before embarking on such a decision.

MAGNITUDE

The magnitude of Mr. Market's mood swing affects your mood. Following a market swing, investors do well to focus on the new target return created and keep an eye toward the goal and not the potential three-car pileup in the rear-view mirror.

When your financial goal is in the distant future, the target return may change very little based upon Mr. Market's depressive mood swing. This perspective is invaluable because a minor change in the target return offers little reason to make any significant trade-off. Of course, if your financial goals are nearer in time, then Mr. Market's mood swings could generate reason(s) to make trade-off decisions.

The bottom line is that the magnitudes of the ups or downs do matter. Bigger moves invite your attention and could invite more trade-offs to be considered (inducing potential decision errors). Smaller moves are best taken in stride (reducing potential decision errors). Smaller moves might be considered ups/downs within 10 percent of the target return line.

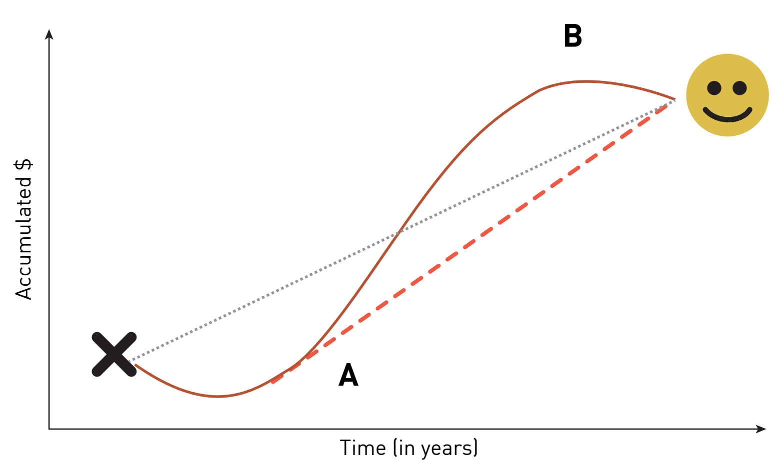
Big market moves, especially big negative moves, however, tend to create big mood swings for investors (you). When this occurs, recognize that your first reaction is likely to be the opposite of what reflection would suggest. Big market drops often tend to make people want to run away. Stop. Reflect. When groceries go on sale, you stock-up, right?[12] Well, investments just went on sale; this may be a good time to stock up.

SEQUENCE

Now consider what happens if the sequence of returns shown in figures 2–4 is swapped, as first shown in figure 5. In other words, what happens if the depressed Mr. Market precedes the manic one?

Figure 5

MARKET MOOD SEQUENCE REVERSED



FIRST, A DEPRESSED MARKET

After the initial losing period of investment returns, your locale is shown by A in figure 5. This new A offers different choices and trade-offs to consider. The good news is that the bad news has come quite early in your investing career, so try not to get discouraged. Yes, the slope of the target return has increased (the red-dashed line), but it is not wholly different from the slope of the original target return line because your funded contentment is so far in the future.

You have the following choices:

You could choose to begin to save more. It is hard to say so many years in advance that saving more will have been necessary, and discretionary savings may be harder to accomplish for a younger investor. But it is undisputed that saving more earlier has the greatest potential to boost the probability of you reaching your financial goals.

You could choose to begin to invest more aggressively. Again, this may or may not prove to be a beneficial idea, because of the long time horizon. Your current investment plan probably still makes good sense because you're still young and your financial goals are still distant.

You could do nothing. Given the small change in the slope of your target return line, choosing to do nothing may be the best decision.

You also could combine choices by altering your savings and your investment risk. Note that combinations could be multiplicative or could offset each other. The results of combinations can and should be estimated, just as you computed your target return, before embarking on such a decision.

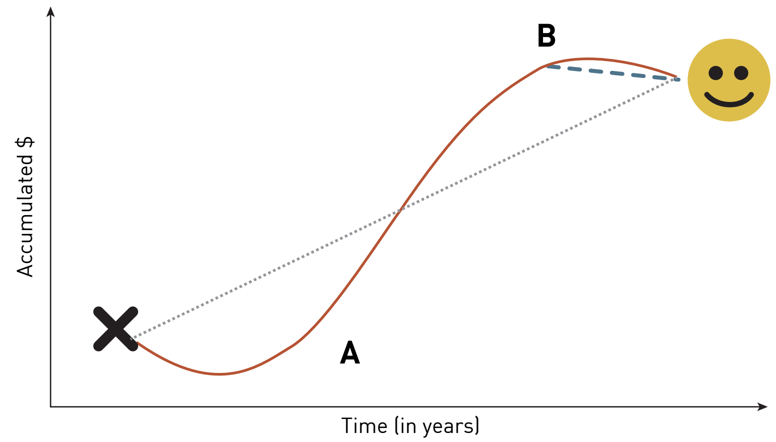
THEN, A MANIC MARKET

After weathering an initial negative market, a subsequent winning period with your investments put you at your new locale B (see figure 6), where you have new trade-offs and choices to consider because your target return now has decreased. Your new path, the blue-dashed line has become roughly horizontal, so your target return is essentially zero, and you have reached your financial goal. Congratulations. However, is it too soon? You have the following choices:

You could choose to begin to save less. Then again, why bother? Most likely you are later in your career, your discretionary income is likely greater now, and you've basically reached your funded contentment.

Figure 6

A MANIC MARKET FOLLOWS A DEPRESSED MARKET



You could choose to begin to invest more conservatively. If you're not ready to accept your success at this time, then why not lock down your success and remove most, if not all, of Mr. Market's unpredictability by investing very conservatively? Note, however, that this is precisely the moment when the temptation of the hedonic treadmill is the most dangerous. Up-sizing your financial goal could take either continued savings or more aggressive investing. If you can resist temptation, you will be satisfied with what you have planned for, worked toward, and succeeded at after many years.

You could do nothing. Doing nothing seems perfectly okay here. But why wouldn't you begin to invest more conservatively at this point, regardless of whether you wish to stop and declare victory anytime soon?

Allow me to be blunt: Given time, your ability to save and invest, and all else being equal, a depressed Mr. Market arriving during your relative youth before a manic one arriving just as you begin to near your long-term goals is the best sequence.

UNDERSTANDING SHORT TERM AND LONG TERM

All investing is probabilistic in terms of the chance of success or failure, and we define risk as the probability of failure to reach a goal. Let's now define how the time distance to financial goals may help you appropriately bias toward conservative (less risky, e.g., bonds) or aggressive (more risky, e.g., stocks) investments.

Long term: The long term is 15 or more years for individuals and 20 years for most institutions. The long term affords mostly aggressive investments and allows you to check where you are on your path as infrequently as once a year.

Short term: The short term describes periods of five years or less and affords mostly conservative investments. It calls for you to check where you are on your path as frequently as quarterly.

All other time periods: Time periods of five to 15 (or 20) years support both types of investments—a diversified mix.

Check where you are on your path at least annually to help reduce your number of decisions and the chance you'll be making reactionary decisions. Of course, major changes in your investment life (institutional plan designs or demographics) are good times to review where you are on your path because the path could have shifted. Consider the following questions for goals that have become more distant:

- Did the goals get bigger? Be wary of hedonic creep and institutional plan design updates.
- Did the savings get smaller? Could you be happy with a lesser goal? Could achieving your goal be delayed by a few years?

Check where you are on your path at least annually to help reduce your number of decisions and the chance you'll be making reactionary decisions.

Long-term time frames become mid-term and subsequently short-term time frames as you approach your goals. There is no such thing as a permanent time horizon for savings (even most of the institutional varieties have recurring spending needs) that will be spent eventually.

NOW WHAT?

To paraphrase a well-known saying, "Simple maybe; just not easy."

Individuals will attempt to save and invest by themselves or they will engage with professionals for assistance. The irony is that all professionals are individuals themselves. So, a user's manual could only help. The behavioral economics literature talks about the differences between who the economists have dubbed "Homo Economicus"[13] and us regular humans. Enough! We are all humans, and we are not Spock-like, silly, or deranged characters in some economist's play. Whether you're an individual investor or a professional, take note of the following steps down the path to funded contentment:

KNOW:

1. Your behavior, defined as your decisions and actions, is more meaningful to your success than the investments you choose.
2. Fewer decisions along with constrained choices (i.e., trade-offs) help enable better behavior.
3. Understanding trade-offs and the directional situations in advance will help you manage your in-the-moment reactions.
4. Your goals are what matter—not what happened in the markets today, last week, last month, or even last year. The past is past; what matters is what is next, and it's opaque to everyone.
5. All paths have some potholes, and some more than others.

DO:

6. Understand what funded contentment means to you; know that this understanding can and will change over time.
7. Assess how realistic your goals are with respect to your savings, your ability to save, and your desired time frame.
8. Re-assess your funded contentment path and re-affirm your path as needed.
9. Track your decisions: path changes, what stimulated the changes, the trade-offs chosen, and rationales for those choices.
10. Look ahead to your goals and look back only to review your tracks, the path taken.
11. Update #6–8 annually or soon after a significant life event. If the significant life event is emotionally draining (e.g., the loss of a loved one), it's okay and sometimes recommended to delay the update and account for it in the next annual review.

SEE:

12. Your tracks can offer great insights about past choices that could improve your future choices. Examine how your goals have changed and observe how your decisions have impacted you. Emotional reactions that cause you to trip over potholes are about you, not your money.
13. Your choices are opportunities that are no different than why sailboats "tack" back and forth to enable better positioning to move forward.
14. Mr. Market for who he is. He doesn't care about you or know about your goals. He may give, he may take, but he never owes or empathizes.

AVOID:

15. Getting caught up in Mr. Market's drama when he is manic or depressed. Feel his push/pull and remind yourself that he doesn't care about you or your goals.
16. Asking, "Are we there yet?" Check your tracks, as suggested in #9. You will undoubtedly know when you arrive.

IF YOU ARE THE PROFESSIONAL:

17. #1–16 is your client value proposition, and they go far beyond selecting investments. A small portion of the public may be able to execute #1–16 by themselves, but most everyone can benefit from a coach, because others often can see our behavior clearly and unemotionally, and because sticking to a program is more the exception than the rule.
18. Be the wise, unemotional council during stressful times. Be a staunch speedbump to reactionary decisions. Be the parent who calmly reminds the child, "We're not there yet."
19. Specifically,
    - Help clients see trade-off decisions clearly.
    - Be a reality check and help manage expectations.
    - Empathize with your clients, because their savings are their lifelines to peace of mind, freedom, security, and their hopes and dreams.
20. Finally, whom do you leverage for #17–20 for yourself? (Got overconfidence?)

EVERYTHING SUMMARIZED

Voltaire is famously quoted as saying, "Doubt is not a pleasant condition, but certainty is absurd," which contains the nugget of my closing advice.

Doubt the permanence of goals, doubt smooth upward paths, and doubt any and all clarity about what Mr. Market will do next. Do plan, measure, reassess, trade-off as need be, and repeat as necessary—that's investing. The actions you take all along your path mean everything when it comes to where you will finish.

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ENDNOTES

1. If not, then it's suspiciously close to gambling.
2. Euphemistically, we can add "life happens" to the reasons that individuals become cash-flow negative or fail to reach their goals. Financial planning is the best way to reduce the impact of negative life experiences on your investment plan. Think of financial planning as, at its defensive core being, apportioning an emergency fund, owning the proper insurance(s), and helping to discipline the magical, i.e., spending less than you earn. A financial plan is beyond the scope of this article; however, it has the capability—more like the responsibility—to support your investment plan (by enabling you to leave it alone).

Continued on page 68 →

EVERYTHING YOU NEED TO KNOW . . .

Continued from page 54

3. Lake Wobegon is a fictional town created by Garrison Keillor as the setting of the "News from Lake Wobegon" segment of the radio program *A Prairie Home Companion*, where all the children were claimed to be above average.
4. Investments aren't discussed here for three reasons: (1) Everyone can simplify investing successfully by using only index funds and a mere 2–4 investments can work pretty darn well; (2) Complicated investments and their high costs often fail to deliver what an index fund can deliver, and they often lead to greater emotionalism (even if it's only "I want to invest in that"); and (3) This article needs to remain brief.
5. Diversification always means that you will be unhappy with something in your portfolio. Think of one dog barking versus the cacophony of an entire kennel. Diversification also means that what you own in your portfolio must not be all the same; the primary asset classes are cash, government bonds, and stocks.
6. Uncertainty is another interesting topic, but it's also beyond the scope of this article. I happen to think that uncertainty aversion is the parent bias from which all other biases spring; for more of my thoughts on this, see my podcast at https://www.youtube.com/watch?v=UIaM0PHhah8.
7. See "Mind the Gap 2019," Morningstar, https://www.morningstar.com/articles/942396/mind-the-gap-2019.
8. If possible, use monthly rolling one-year results versus the calendar-year results.
9. Hedonic adjusting is about never-ending, upward, "quality" adjustments and the belief that bigger and more is always better.
10. See Barry Schwartz, *The Paradox of Choice: Why More Is Less* (New York: HarperCollins Publishers Inc., 2004).
11. If it helps, your values may be lower but the number of shares you own isn't; values bounce around and can bounce back. The best question is how long until the bounce back may happen. Here's an interesting simple process: https://klementoninvesting.substack.com/p/invert-always-invert-the-covid-19?r=1iqfp&utm_campaign=post&utm_medium=email&utm_source=copy.
12. Be careful with perishables. For stocks, stock-up on those companies that likely will still be in business in 10 years. Then again, with a stock index, this largely is done for you.
13. This was done as a convenience for economists' theoretical work. Homo Economicus is all-knowing, perfectly selfish, unemotional, and a 100-percent fictional construct, see https://en.wikipedia.org/wiki/Homo_economicus.

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