Investing in Equities
AND MANAGING RISK

Investing for the most important financial events of your life

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Investing in Equities and Managing Risk

The most important financial events of your life are certain to come.

Your children will go to college and you will need to pay for that. You will retire one day, whether voluntarily or involuntarily. The great financial goals of your life are certain. And yet, the way we invest to meet these milestones is anything but certain.

No doubt, there is a very real possibility that your stock investments will fluctuate in value over time as you attempt to achieve these goals. Sometimes, their value will go down a lot in value in a short period of time. And you will have to pick what you are going to be scared of: the very possible, but temporary, declines in value of a stock portfolio or the certainty that college costs and retirement will come no matter what.

There are few engines for growing real wealth like stocks. For many, access to the stock market is the biggest opportunity they will ever have for generating wealth.

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Let's just be frank about equities: stocks go up.

If you were born after 1935, stocks have been going up your entire life. Stocks have always gone up. If you lose money in stocks, you have done something incredibly wrong.

Indeed, it takes an immense amount of creativity to lose money in stocks, yet many people do it all the time. And still more miss out entirely; the fear of losing money in the stock market paralyzes some people to the point that they never get on, what one commentator calls, the "great train" of equities.

Where I find most people fail in their stock market experience has nothing to do with the stocks or mutual funds they selected. It had everything to do with the psychology and perspective they brought to the table from the beginning. Let us try to establish some reference points from which to begin our discussion on equities and the risks inherent in them.

Success in investments (stock, mutual fund, real estate, etc.) requires patience, a fundamental belief in the progress of the world and the right perspective. Investing is a marathon, not a sprint. Watching the daily or monthly values of your investments is like measuring a marathon in inches rather than in miles. Success will take time and you have to be prepared to put in the time.

It's not a matter of if these investments will go up; it's a matter of where your money will be when they do go up. Will you still be in the market when it booms? Or will you have been on the sidelines waiting for the "right time" to get in, only to find that the "right time" has past you by again?

But, you have to get started first. There's always a reason to procrastinate; there have always been problems that seem insurmountable, like wars, recessions, presidential elections, etc. There is always a "reason" not to invest if you are short sighted. But realize that the people who have continually invested despite the apparent difficulties are certainly closer to being financially secure than those who did not.

These visionaries have come to realize that long term financial security is purchased at the price of the short term - but ultimately negligible - uncertainty of the stock markets.

The Biggest Risk in the Great Companies of America – and the World

If you have ever heard a person say he/she could never own stock because it is much too risky, we should be reminded (as should they) that the biggest risk in the great companies of America and the world has always been - and continues to be - in *not* owning them.

Investment losses in the ownership of great companies have always been temporary. Does McDonalds' stock value go down from time to time? Surely. And yet, ever more McDonalds continue to be built and each store continues to provide more and more profit to the company's bottom line. A temporary price decline in a stock like McDonalds becomes permanent only when you panic and sell.

One Dollar Invested in 1925 grew to be how much by 2020?

If invested in	Your dollar grew to be	Annual return
Small stocks	$46.792	12.1%
Large Cap stocks	$8,680	10.0%
Long-term Gov't. Bonds	$172.52	5.56%
Treasury Bills	$24.82	3.4%
Inflation	$14.95	2.86%

Over time, advances in the value of the great companies continue and temporary declines vanish. Advance is permanent, decline temporary.

Contrast this with the money markets, CDs and the Treasury Bill, which provide an illusory, short term sense of security but barely keep pace with inflation. Once inflation and taxes are considered, these "safe" investments simply rob you of wealth and cause, with great irony, long term insecurity.

Short term fluctuations in the value of your portfolio are the inevitable price you pay for superior returns over time. If you do not or cannot stomach the fluctuations, the price you will pay is your long-term financial security. For the vast amount of the general public, only equity investments will get them to their long-term financial goals and meet their long-term financial needs.

Putting Your Principal at Risk – a Necessary Medicine

I fear I have brought you to a rather uncomfortable point; I apologize if I have. But it is necessary medicine.

Rather than making you comfortable with putting your principal at risk, I simply want to make you very afraid of not doing it. That does not seem very "cozy," does it? It seems odd that I should be trying to persuade you to re-think your approach by making you more scared about risk than you already are. And, you would be right to think that. But if you are to be successful, you must understand and confront risks of all kinds.

Risk Management: Nuanced Approaches to Mitigate The Risks Inherent In Equity

Now that I have unashamedly promoted equity investments, let me take a step or two back to discuss some of the more nuanced approaches to how one can mitigate the risks inherent in equity investing.

Face it, there is no perfect investment. To be sure, there are good investments and bad investments. If we could simply know the good from the bad ahead of time, we would surely take the good ones and leave the bad ones behind. Clearly, not all equity investments turn out well for amateurs…or for the pros. There really is risk in this kind of investing, and losses will occur. Nevertheless, there are tried and true approaches which mitigate the risks and which, in fact, can help the risk work in your favor.

The Notion of a “Good” Investment

Before we look at the specifics of risk management, let me take a moment to refine the notion of a “good” investment. I mentioned above that if we knew good from bad, we would always choose good investments over poor ones. But what constitutes a “good” investment?

At its essence, a good investment is one that is financially sound, generates a return commensurate with the amount of risk you are incurring by owning the asset, and stays true to its intended purpose. By this, I mean that the underlying asset should not deviate from its original intention. If you are buying a Utilities based mutual fund because you need stability of principal and a solid dividend, you do not want to open up the fund’s annual report and find that what the funds really owns are a bunch of high tech companies that could crash in value.

So, you need investment return commensurate with risk and, you need consistency of style.

This is a good start, but we need to do more. We must further refine the set of “good” investments into a smaller subset of what I call “appropriate investments.”

Take for example a 35-year-old, classic Cadillac in mint condition. Is this a good investment? Well, maybe. If you live in Arizona and are upper-middle class, then maybe it is a perfectly good investment.

There would seem to be considerable value to owning it as you could drive around town looking cool. And, you could likely find a willing buyer in the area who would be happy to take it off your hands when the “joys” of car care wear off. But, what if you are an Inuit Eskimo living on Attu Island off Alaska?

I suspect this “classic” car would be nothing but trouble. Certainly, it would not be a good investment of time or money. The point is that value is not necessarily in the product. Rather, the value is assigned by the person(s) who use and will use the product or service.

Additionally, we must recognize that not all “appropriate” investments do well in all economic circumstances. We need a stable of appropriate investments combining numerous traits and characteristics so that we can create a balanced portfolio. “Balanced” here means a portfolio that has an opportunity to reap the rewards when times are generally good and to protect your principal and income when times are not so good.

Asset Allocation: One of the Biggest Breakthroughs in Financial Research

The technical term for this concept of a well-balanced combination of appropriate investments is Asset Allocation. You probably know this better by a lesson your mother or grandmother taught you many years ago: Don't put all your eggs in one basket. It is, quite literally, one of the biggest breakthroughs in financial research ever developed

As we have previously discussed, no investment is perfect. Each serves its purpose in a given timeframe and for a given level of appropriate risk. Extensive research has shown us several interesting facts that are the basis for Asset Allocation theory. And, we can use these findings to our advantage in managing investment risk. Most notably, in every 25-year period of measurable investment history, it is always the case that aggressive growth investments have outperformed growth investments. In turn, they have always outperformed growth and income investments, which have outperformed income-oriented investments, which in turn have always outperformed cash and its equivalents.

This is almost a law of nature: in every meaningful period of investment experience, the higher the risk (also to be interpreted as "the higher the uncertainty of value at any one time,") the higher the investment return is over time.

The Most Reliable Type of Investment Over the Short Term

While we know that you will need to use some of your money this year and next year, it only makes sense that a portion of your investments should be cash and its equivalents, since that is the most reliable type of investment over the short term.

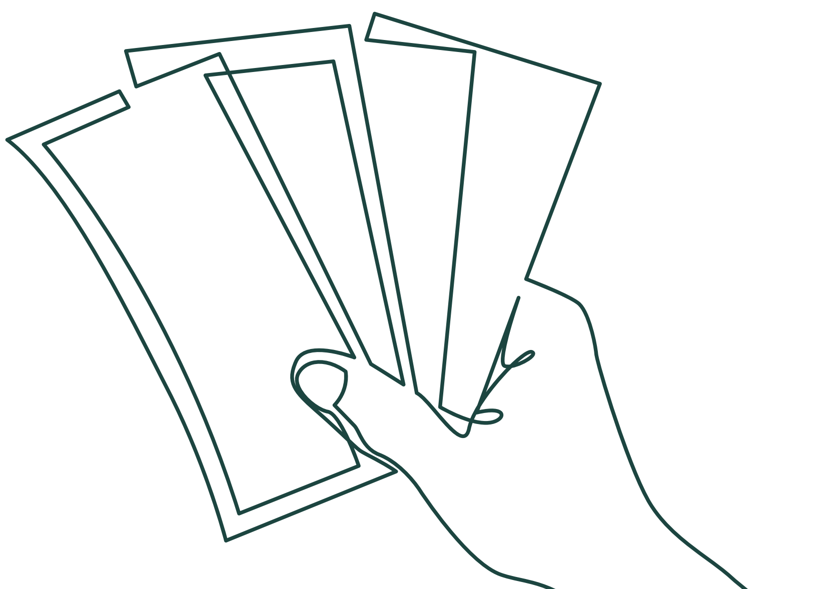
Likewise, if you are not retiring for another 20 years, it makes sense to allocate the majority of your 401K money toward growth and aggressive growth investments as they are the only reliable type of investment for that time period. “Reliable” here means that they have the best chance of growing and maintaining real wealth relative to the inexorable ravages of inflation.

The art of asset allocation is simply to blend the timeframes over which money will be invested with the various, time-specific needs for money you will have over your lifetime.

The resulting mixture of time appropriate (short-term, intermediate-term and long-term) investments will constitute your asset allocation.

One fascinating and important result of a properly allocated portfolio is not necessarily all that intuitive. A portfolio allocated across the asset spectrum will almost always produce a higher return over time than an unallocated portfolio, and it will almost always do it with less risk. You read that correctly: a properly allocated portfolio will almost always raise the return over time and reduce the risk.

That’s why in our practice, we do not make any important investment decision without first creating a custom asset allocation for every client. I am so adamant about this that I will not take on a client who does not agree to first create an allocation. In fact, we don’t even let clients go to the bathroom without first making an asset allocation plan. Well, we’re not that adamant! But it is vitally important.



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Further Reduce the Risk You Face with Dollar Cost Averaging

Once you have a game plan for diversification, how can you begin implementing it to further reduce the risk you face? One of best approaches we use is Dollar Cost Averaging (DCA).

Know it or not, you already do this if you contribute to an IRA, 403B, or 401K plan on a regular basis. And that's a good thing because dollar cost averaging works. Here's why. In broad terms, the stock market goes up in value seven out of every ten years. That's right! History tells us that in any one year, the probability of the market going up is 70%. If we look at each five-year period, the success rate goes up to 90%. How can we lose?

Of course, the problem is that the market does not always go up. In fact, in most years, there will also be a time when the market drops 10-20% from the highest point during that year. We have just noted that from January 1 through December 31, the market rises about seven times in every ten years. But in every one of those years - seven winners and three losers on average - the market will likely drop at least 10% from its high point during the year. Increasingly, we find that the drop is becoming more closely centered on a 15% drop from the top - and that's EVERY year!

There is much volatility day-to-day and month-to-month. That's why people don't think the market is a safe place to invest. One day it's up, the next day it's down, and sometimes it's down a lot! The fluctuations make potential investors nervous, often paralyzing them from making more investments or worse, to stop investing altogether.

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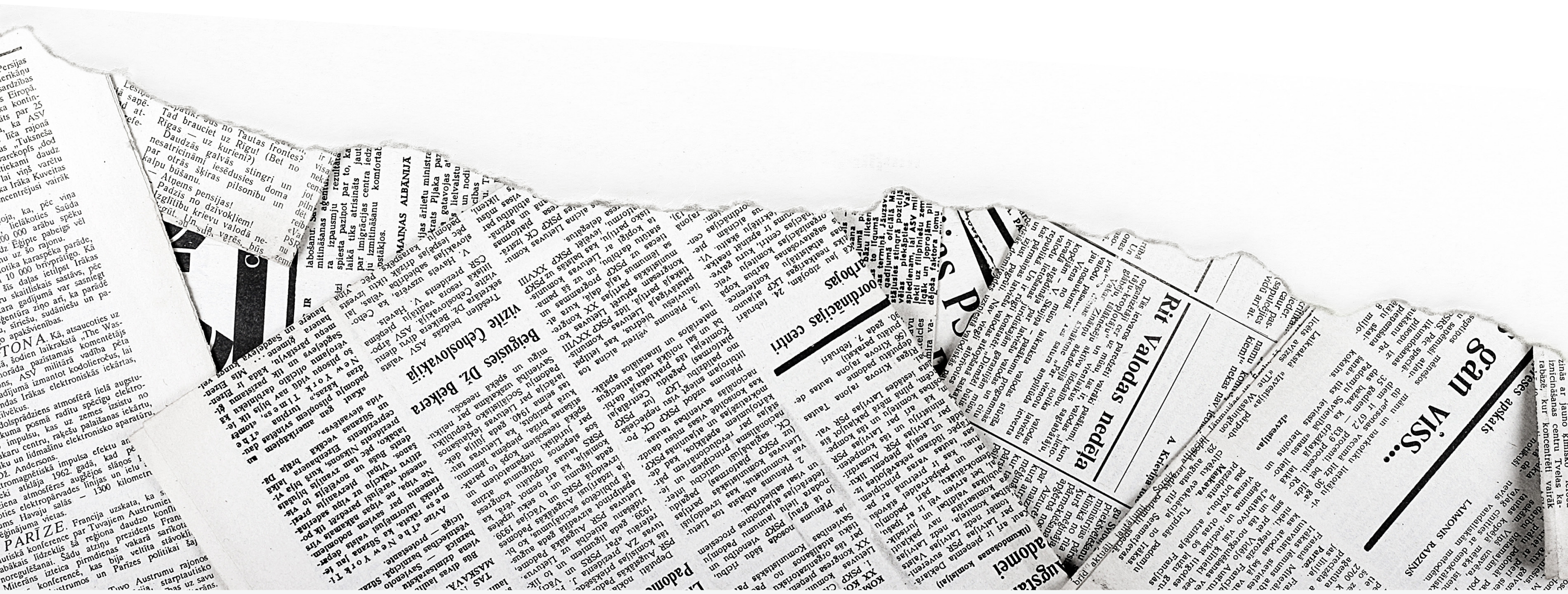
Losses Make Headlines; Gains Do Not

A scary day in October 1987 comes to mind - the market dropped 22% in one day. Panic was everywhere!

Yet, had you been in the Peace Corps that year or recovering from back surgery or involved in some other activity that caused you to miss the news of that fateful day, you would have found that the market was actually up that year. From January 1 to December 31, the overall market was a winner, even with that tumultuous, scary, disastrous - but ultimately inconsequential - day.



The real news is that the trend of the equity market is, and always has been, up.

It always seems that the drops are more dramatic than the rises because losses make headlines and gains do not. The temporary drops in the market make it on the nightly news, but the real news is that the trend of the equity market is, and always has been, up. Of course, that October day in 1987 was only inconsequential to those who did not panic.

For those who did panic and sold out of their investments, the fact that the year was a net positive was of little consequence to them. They guaranteed their own ruin by failing to abide by the knowledge that all drops in the market, however horrific on the surface, are all temporary. So, if things are so volatile and uncertain, what is a relatively conservative investor to do? The answer may be Dollar Cost Averaging.

When you really think about it, this concept is not all that remarkable. When you go to the grocery store expecting to buy two cans of tuna for $1.99 each, and you arrive to find that the price of tuna is 49 cents per can because of a “manager’s special,” what do you do? You load up, right?

Human Nature in Economic Life

In every aspect of our economic life, we have learned that when the price is down, we should buy more. Buy-one-get-one-free promotions are very successful because they grab our attention. It's a great deal in many cases; but why then, do we not act the same way when the market is low, and stocks are "on sale?"

What is it about human nature that says buy lots of tuna fish, buy an extra pair of shoes, buy four tires instead of the two you really need when the prices are down, but that same human nature says, "not only should I not buy more shares when the price is down, I want to sell all the shares I currently have at this depressed price?" You and I both know what it is. The simple human reaction to falling stock prices is the fear that things will continue to go down. And down. And down some more until the price is zero.

Of course, as we have already discussed, the great companies of America and the world will not go to zero. They will simply go "on sale" from time to time, just like the tuna fish. But where will you be when that happens? Will you be in the buyers' line or the sellers' line?

The use of DCA forces you - against your human instinct - to do exactly the right thing. By investing the same amount of money every month (or week or year), you force yourself to buy more shares when the shares are cheap and to buy fewer shares when the price is high. It forces you to do exactly what you would do in every other part of your purchasing life.

All Big Dips Are Temporary

The people who benefited the most from the bull market of the 1990's and again in the 2010's were not the people who got in and made their first investments in the 1990's or the 2010's.

Despite the ups and downs of the 70's (mostly downs) and 80's, the people who had faith that their continued purchase of relatively cheap shares would pay off were more than well rewarded by the boom of the 1990's.

The same is true for those who persevered through the internet bubble of the early 2000's and the financial crisis of 2007-08.

To be sure, in every era of investing, a big dip in stock values is coming. It always is. As I write, both the Dow and the S&P 500 hit their all-time highs around Feb 12, 2021 less than one year after having one of the all-time biggest drops in March and April 2020.

So, the next time you think the market is about to tank, please look at me (metaphorically speaking at this point) and tell me three things:

1. You agree with me: this next dip in the market will happen and it will be **temporary.**
2. You know it **doesn't matter** in the long run.
3. At the very least, you will continue to leave your current assets **invested,** continue your DCA efforts, and if at all possible, buy more shares.

If you can solemnly promise me these three things, you are a true convert to the power of Dollar Cost Averaging

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Constant Ratio Transfer or Re-balancing

Further research has also shown that a strict policy of re-balancing your asset allocation on a regular basis will further boost return and reduce risk.

By implementing a re-balancing strategy, or more precisely, a Constant Ratio Transfer (CRT) strategy, we can systematically sell off the asset classes that have grown larger relative to the others, while using the proceeds to reinvest in the classes that have become relatively smaller.

Get into the habit of selling high and buying low: exactly what we should do all the time.

The asset classes that have relatively risen in value are now more expensive because the prices are higher. Likewise, the classes that have become relatively smaller are now cheaper.

By selling the high ones and buying the low ones, we are forcing ourselves to get into the habit of selling high and buying low: exactly what we should do all the time.

Conclusion: You Must Not Be Afraid

Asset Allocation strategies and the implementation of them are useful tools for mitigating the underlying risk of investing in equities. But, sometimes it is not readily apparent. The idea of diversifying is usually best understood in hindsight.

An old colleague of mine used to say: "Anyone can swim in waist deep water." What he meant was that when times are good, any kind of investment strategy works - diversified or not. Know anybody who was committed entirely to technology stocks when the bubble burst in the year 2000? Or financial companies in 2007-08? Of course, diversity shines best when times are worst. The point I am getting at is this: when are you in over your head? When is the water no longer waist deep? More importantly, who will be there when you are in over your head and you are starting to feel the odd sensation of drowning in your own investment pool?

The flotation device that helps you keep above water and paddle safely to shore is the professional advice that comes with an investment plan. A good investment plan has a coherent and reasoned response to important questions. It uses extensive Asset Allocation strategies; it implements Dollar Cost Averaging and Constant Ratio Transfer. It manages investment risk. Remember these tenets. If you are reacting to every daily market move, you are gambling, not investing. If you are easily swayed by daily market "news," then you are a short-term thinker and thus, a speculator. But if you are goal-oriented, focused on the long term, and following an investment process based on sound principles, you are an investor. Pure and simple.

All successful equity investing is about time - not about timing.

Short term swings mean little for the long-term investor. Indeed, as a long-term owner of equity investments, such short-term dips in the price allow you to accumulate more shares at an attractive price.

While a sale on the great companies of the world - i.e., a real, but ultimately temporary, stock market decline - is a possibility, you must not be afraid of that. We can hedge against that possibility by using Asset Allocation, Dollar Cost Averaging, and Constant Ratio Transfer.

In fact, we can use any temporary downturn to our advantage in an effort to confront the certainty of funding our children's education and our own retirement. The long-term upward trend of equity investing, and the wealth it provides, is reward for enduring the very real challenges of a lifetime of saving and investing.

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