Planning and Portfolio Meet at the Behavioral Crossroads

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The single best piece of advice, which I received early in my career and have given hundreds if not thousands of times in the past 20 years, is a combination of planning and investment advice.

Before you invest you have to know what you are investing for.

"Making more money" is not an investment goal.

"Beating the market" is not an investment goal.

"Beating your neighbor, friend, or wife's brother" is not an investment goal.

Each of these is a setup. The things that you might do to accomplish each of these things, the things you might do to produce bigger and better returns in some short period of measurable time are often the very same behaviors that ultimately produce smaller and worse returns over your entire investing experience.

This is because the human mind is naturally a speculator (not that it is good at it, but that it is the natural tendency). Humans tend to equate price (what everyone seems to be willing to pay for an investment) with value (the intrinsic, even if only projected, real future cash flows available from the investment). By equating them, we are attracted to higher-priced investments, and we are afraid of lower priced investments.

Price is easy to determine. Value is hard. Price is exciting. Value is boring. Price is a conversation starter. Start talking about value and watch as eyes glaze over and people nod off. Add to these the fact that most investments are less tangible than the usual things we buy. When we go to the grocery store we know we are exchanging $1 for a can of tuna. If we can get the same can for 75 cents, we know that is a smarter choice.

It doesn't work this way with investing. When we are investing and we are focused on "beating the market," then we ultimately end up placing more and more of our money in higher and higher risk situations in order to do so. This is a process. When we start, we say to ourselves, "I understand that risk and reward go together, but I don't want too much risk so I will limit how much if this risky investment I will buy."

Time passes, that "risky" investment produces two times the performance over a different investment and we start to wonder if limiting our exposure was a mistake. More time passes, more relative underperformance under the bridge and we cave. Our risk discipline gives way to price chasing. Our lizard brain takes over. And

if the risk investment goes up before our next statement, we get confirmation of our brilliance. We feel righteously justified and believe our good decision has created additional returns.

We will be wrong. We have ditched our risk discipline in favor of chasing returns, and we have added risk to create those extra returns. Ultimately, the further we go down this road, the closer we are to the next market problem and losing a third (plus or minus) of our capital. Please don't take my word for it, look for yourself and you'll find that there have been 13 bear markets in the past 70 odd years that resulted in the loss of a third of our invested capital. I don't think I need to explain how building your risk exposure as we approach a decline is really bad for your long-term portfolio. Yet, this is what the statistics tell us we do en masse.

On the flip side, when we hear about a great investment, and we do our research before we buy it for $100, then something unforeseeable happens and that investment falls to $75, well, let the second-guessing begin. Even if there was no fundamental change in the company and future cash flows haven't changed, we get nervous and our natural tendency is to sell. If you repeat this often enough, you can lose an awful lot of money.

But if we have a plan to know what we are investing for, and we know that we have seven, 10 or more years until we need those future cash flows to begin, and we have perhaps 30 years or more (the average retirement) that we will need those cash flows. And we know, because we have planned using a cash flow analysis, that those future cash flows will be enough. And we understand, because our plan has been stress tested, that this kind of volatility is expected and completely natural. Then, we are able to short circuit this natural tendency to panic out of markets that are inevitably volatile and anxiety producing.

There's nothing we can do about our human proclivities or about the volatility of markets, but knowing where we are going before we start, understanding the real trade-offs we have to make to get there, and understanding the likely outcomes on the path keeps us from making stupid, but very human, errors along the way.

Understanding how the portfolio completes the plan in the long-term supports improved behavior in the short term. If you don't plan, then you tend to succumb to short-term volatility and reduce the long-term benefits of the very risk you are taking.

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