Saturday with Jim: Investing Should Be Dull

I observed something about my investing behavior a few years ago. Whenever I found an investment that just "couldn't lose," it always did. The ones I had little faith in? They usually gained. Since I always looked for investments which "couldn't lose," you can imagine the results in my personal portfolio. It was not hard to find the culprit - my emotions. Filled with glee, I would pile on an investment which was doing well. Unfortunately for me, the people who bought when the security was cheaper and who sold it to me made the most money. I tended to buy a rocket at its zenith, just as it was about to make its inevitable descent. A 92 pound investment weakling, I determined to be one of the people who bought early and sold before danger signs became panicked selling, depressing prices in a hurry. Making the change was not at all easy. I had to conquer my emotions, those creatures of our nervous systems which move us to action. I had to, in a nutshell, remove emotions from my investment behavior.

Emotions serve a valid purpose in evolution and survival. Fear can remove us from danger; disgust can keep us from eating things not good for us, like spoiled food, and so on. Greed? It's not a basic human emotion per se, but it's related to the satisfaction of desire. Inevitably, an investor who employs emotion in her/his work is sorely tempted to buy at the top and to sell at the bottom. After all, in an emotional crunch long-term plans go out the window, sacrificed by emotional exigency. It's not that we don't have emotions - we all do. It's just that emotions cloud our vision and judgment just when we need to think logically. We tend to be happiest as investors when markets are roaring and are least happy when they are not. Opposing the prevalent direction, fewer sellers means better selling prices; fewer buyers means better buying prices. But you know this. Just as hard on you, though, is over-analyzing short-term performance (one month or one quarter) and forming trend conclusions based on your analysis. Given that it's human tendency to extrapolate recent performance into the future and that each of us has a different tolerance for the ambiguity of changing account balances, just how do we cope in our endeavor to make your accounts perform in a way that will be acceptable to you and to your emotions?

Finding Just the Right Combination

First and foremost, money which is needed within a year should be kept liquid in a bank account as a reserve against unemployment, illness, etc. Most of us do not have such prescient insight, so we are forced to guess how much we need liquid.

The rest? It should be invested to gain more. But the gains will not be linear. They will come in fits and starts, tempting one to buy high and to sell low. But we've said this.

Having a few months' expenses liquid allows you to relax about your investments and let them do their work. In our case, as income investors, we are most concerned about the health of our "feeder" stock, the capability of our investments to generate income. Income strength has a poor correlation with market price (which feeds into account balance). How do you as an investor feel that you are always okay, that your income is secure? The key lies in the subheading above - finding the right combination of investments which do not give you angst.

How to Find the Right Combination

All investments have qualities that are usually known. By this, we mean that investments usually travel in a fairly predictable path in association with known variables. The price of a government bond, for example, usually travels in lock step with the level of interest rates. Knowing the factors which affect investments, one can craft a "portfolio" with an expected risk and volatility level and an expected

return. Note that the expected return, in the case of prices, is an educated guess at best. Income, on the other hand, is quite predictable. So it is that we employ our knowledge about your needs and risk capacity to fill your portfolios with appropriate investments. But sometimes something comes along to completely upset the "normal" calculus. This something pushes prices way above and way below the expected trend. Neither should be welcomed by the unemotional investor, for surely prices will revert to the mean or thereabouts. Our emotions can cloud our judgment, especially at or near extremes.

The right combination of investments for each of us will not push our emotional buttons. This said, the right combination of investments must also fit our goals and financial needs.

A wealthy person with a very modest income need in relation to the size of her/his portfolio can invest in bonds for the most part. Bonds are both less volatile and safer than stocks, but they return less over long periods of time such as a retirement might be. Stocks, on the other hand, are more volatile but they often have higher yields and growing income - the great majority of bonds have only fixed income. This said, it is possible to "hedge" a stock portfolio to make it return more than a bond portfolio while having less volatility than stocks usually do. It is also possible, and recommended, to craft a portfolio of both stocks and bonds, varying the proportion of each according to attractiveness.

The Take-Away

It is our job to know you well enough to be able to design investments which will neither inflame your passions nor create fear and angst. But we are not perfect nor can we plan for every exigency. Thus, a person who expects to gain more than s/he would gain from a guaranteed investment such as a CD must expect to occasionally be stressed, if even a little bit. It is our job to make this stress bearable, within the limits of your tolerance even while our work satisfies your goals and your needs.

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