

THE ART OF DISCIPLINED INVESTING

BY BOB FRENCH

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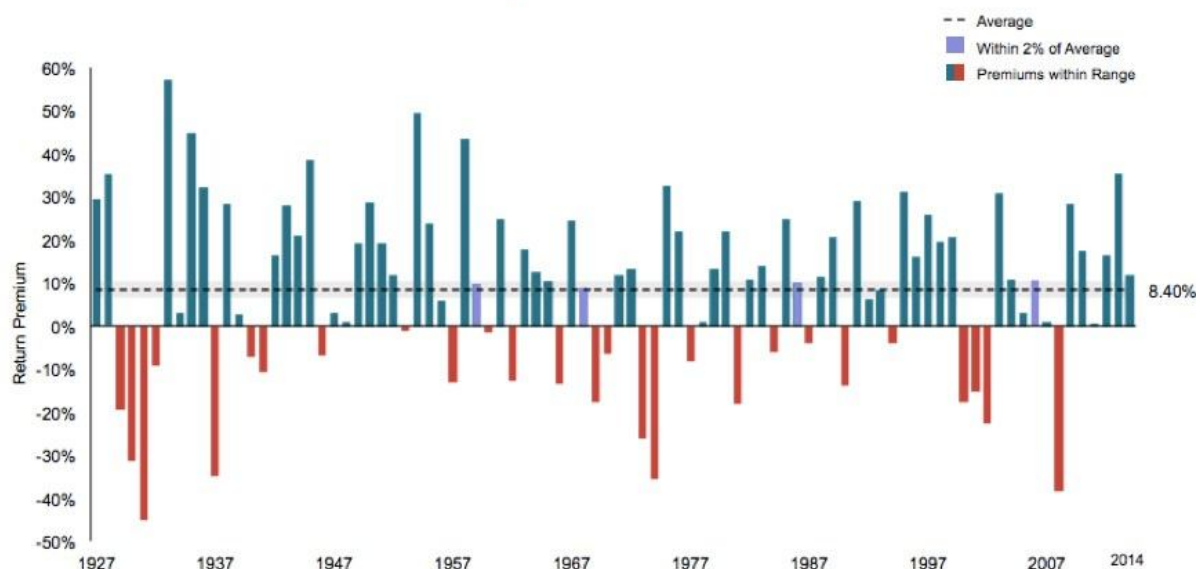
<https://www.mcleanam.com/the-art-of-disciplined-investing/>

Often the least sexy advice is the right advice. It's not exciting, but it will accomplish your goals. This goes for investing, too. Think of your portfolio as a farm. You'll have good years and bad years, but if you focus on the important parts and don't let yourself get distracted, you'll reap the rewards when the time comes. Just like farming, we don't know which cornstalk will grow the tallest, or which will be hit hard by insects. We don't even know how the weather will affect the crops throughout the year. There is risk involved. Again, it's not sexy risk, but it is risk nonetheless. Investing means taking some degree of risk. Accept it and calibrate it to your comfortable level.

WHY ARE INVESTORS REWARDED?

Disciplined investing is rewarded by the financial markets because capitalism, by and large, works. For investors to put their capital at risk there needs to be a commensurate expected return. This is finance. Everything else is just details. Investors are rewarded for taking risks. That means that sometimes that return doesn't appear. In fact, if you look at the equity premium, or the returns of stocks minus the returns of short term US Treasury bills, it's actually pretty rare for the premium to be close to the average. Financial markets jump around. What matters is that you are willing and able to stay in the market to capture the returns you're entitled to for taking that risk.

Yearly Observations of the US Market Premium Market minus one-month Treasury bills 1927-2014



Data provided by Fama/French. Total US Market Research Factor (total market minus one-month Treasury bills). Past performance is not a guarantee of future results. Values change frequently, and past performance may not be repeated. Securities of small firms are often less liquid than those of large companies. As a result, small company stocks may fluctuate relatively more in price. Even a long-term investment approach cannot guarantee a profit. Economic, political, and issuer-specific events will cause the value of securities, and the funds that own them, to rise or fall. Because the value of investments will fluctuate, there is a risk that investors will lose money. Information provided by Dimensional Fund Advisors

TRYING TO OUTGUESS THE MARKET DOESN'T WORK

Investors often try to outguess the markets by attempting to predict the next Apple, or the next hot sector or country. No evidence exists showing that this does anything other than hurt returns in the long run. These are people who are trying to do their best, and by doing so, they are actively hurting their financial futures. Simply determining the level of risk you are comfortable taking and staying put will put you far ahead of most people in the market.

ASSET ALLOCATION MATTERS

Whether an investor is able to stay disciplined really comes down to asset allocation. Asset allocation refers to how you apportion your investment holdings across investable assets, being cash, bonds, equity and property etc. When you decide your asset allocation, what you are really deciding is how much risk you are going to take. There are a number of things that play into this decision:

- Your future needs – what are you saving for?
- Your risk capacity – How much risk can you afford to take?
- Your risk appetite – How much risk are you willing to take?

All of these come together to help determine your risk tolerance. Using this, you can determine the lowest amount of risk that will get you to your goals. The ultimate goal is to meet your objectives with the fewest number of sleepless nights possible. Your asset allocation is your risk tolerance put into practice. Two reasons people don't follow their asset allocation: they are afraid of losing too much money, or they're afraid they won't make enough money. If you are worried about losing too much money, you may be taking too much risk and probably want to reconsider your asset allocation. Just remember, reducing the level of risk in your portfolio will decrease your likelihood of losing too much money (whatever that means to you), but it will also decrease your ability to make money. Risk and return are directly related – the lower the risk level, the lower the expected returns. As far as the fear of not making enough money goes, remember the numbers from earlier. Simply staying disciplined puts you on better ground than most people. It's not sexy, you won't have great stories at parties, but you'll be set in retirement. You might also consider your asset allocation, but remember, risk and return are related. Higher returns require a higher level of risk, and that means accepting higher losses. There is no "correct" asset allocation. As long as your asset allocation allows you to practice disciplined investing and reach your goals, it works.