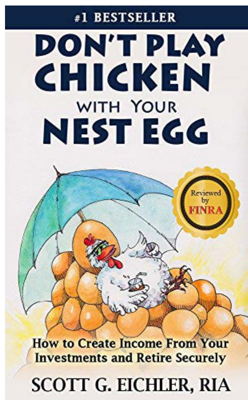

All Investments Are Simply Tools

You shouldn't necessarily have a lot of tools. Some families need more tools for their job than others. Some families need fewer tools. The question is which tool should you use?

Tools are important. The ability to use those tools for their intended purpose is equally as important. Let's assume I have to hit a nail into a piece of wood. Also, let's assume you're my boss and you hand me a saw to drive the nail. First, I would assume that you were an expert and have handed me the proper tool. I would work like crazy to drive that nail. It would probably take me forever, cause me injury, and result in a botched job. That's investing for most people. They have good tools that are being used improperly. But first, we need to know the basic premise of how the tools work. In the case of construction, tools work through force. You smash the head of a nail with a hammer; you grind sharp teeth against wood and force a certain amount of wood pulp out of the way with a saw. What drives the tools of investing?

What is the purpose of investment tools? The purpose is to provide returns. This sounds foolish and painfully obvious, but consider how these tools create returns. Different tools create different amounts of returns. Each tool takes on a specific set of risks. Going back to our saw analogy, how does it work? It has a serrated edge that slices through wood pulp and displaces, while discarding, the cut wood pulp, in the form of sawdust. If you heard this description and someone told you to use a saw to hit a nail into that piece of wood, you would look at that person like he had carrots growing out of his ears (or hit them with the saw).

NOTE FROM THE AUTHOR

Thanks for downloading this excerpt from my book, ***Don't Play Chicken with Your Nest Egg***. The following is a collection of some of what I think is the most important concepts for investors to learn and utilize regardless of market conditions. Hopefully, you will find value in this and our weekly email series.

As always, please reach out to me at Scott@standingoakadvisors.com with any questions you may have.

The Benefits of Being Boring

There is nothing in life quite so exhilarating as being boring.

Come again?

Don't misunderstand, I don't want you to be boring or your life to be boring, just your investments. I want your portfolio to be as boring as possible.

Before we can make investments boring, we have to realize one simple truth. Your portfolio is either at an all-time high, or it is down. There is an old Chinese curse that says, "May you live in interesting times." The volatility of the market has become very interesting. I suppose congratulations are in order since we've all been cursed. How do you free your investments from this curse of volatility? The short of it is, you can't. You can't free individual investments from this curse. With any luck, you can limit the curse on your overall portfolio. It takes work. The good news is that this work is possible. How can we accomplish this? For that answer, we turn to endowments. More specifically, we turn to the large endowments of major universities. For decades, endowments have been the shining city on the hill. They have performed well in up markets and in down markets. The key to their success has largely been their ability to diversify.

The nature of investing is that people get too excited and people get too depressed. Both things make humans invest like crazy people. This translates into the rollercoaster ride of publicly-traded investments. When things are great, we pile on and push markets to unsustainable levels. When the unsustainable levels suddenly become, well, unsustainable, the market begins to fall or "correct" (implying that the market was wrong and not the investors). As it "corrects," everyone "freaks out" and "jumps ship." This causes the prices to fall faster, and investors typically jump ship faster. These aren't necessarily people who are attempting to time the market, but people who succumb to fear. The result of all this up and down is called standard deviation (in statistical circles). The rest of us call it "change." In an ironic turn, standard deviation typically turns the average person's dollar into change.

Living with Risk

Risk seems to be one of the rules of investing that is poorly understood by many investors. Perhaps "poorly" isn't the right word. Investors have a very limited understanding of risk. I hate the word "risk." It isn't because I hate risk or hate thinking about it. That's as silly as hating the ocean tide. You know it's there; you know it will be there tomorrow. I hate that I cannot imagine another industry that has so thoroughly botched the use of a word that is so crucial to its functioning. The investment community does nothing so well as communicate poorly. The word "risk" is a prime example of my industry's inability to communicate.

Risk, in general, should not be viewed as fluctuation. No one is concerned that their portfolio is rising too fast. Everyone is concerned when their portfolio shrinks, even a little. When I sit down with a family to review their situation, the word "risk" arises quite a bit. What do they mean by risk? 99.99% of the time, people mean the likelihood the market will fluctuate down. The unspoken concern is that the market falls for no good reason (meaning you can't predict this risk). This, in their minds, encompasses all risk, the unexplained, fickle whims of the marketplace. It is true that the market is subject to the whims of people trading. In the industry, we call this market (or sequencing) risk. Families who work with my firm are taught that this is called "market risk" and does not encompass all forms of risk.

Risk is a broad and diverse topic. Risk affects your portfolio in a negative fashion, so it is important that you understand the forms of risk. What places negative pressure on portfolios? First, you need to understand one thing. Every investment takes on risk. Every single investment. A potential client often comes to me with the following statement: "I don't want to take any risk." I respond, "Do you have any money?" They respond with their version of, "Well duh ... I'm here meeting with you." I reply in kind, "Your money is always at risk, has always been at risk, and will always be at risk." It isn't a question of whether your money is at risk, but what kind of risk it is taking.

"Your money is always at risk, has always been at risk, and will always be at risk."

Second, you need to understand that risk is not bad. Risk just is. You can't get rid of all risk. While you may hear about "risk free" investments, it simply means that someone else is taking the risk (and, to some degree, the reward of returns). If we are being specific, "risk free" means that the investment is free of one type of risk. Sadly, in turn, it takes on other risks to eliminate that one risk. Risk becomes a problem when your investments focus on one type of risk. If you have an all-stock portfolio, you are heavily weighted in "market risk." At some point, market risk is going to rear its ugly head, and you will complain to your friend that you "took too much risk." In a certain way, it is true. You probably did take too much "market risk." You want to diversify that risk. Let's review some different forms of risk that can affect your investments.

Market Risk

Why don't we start with the risk with which you are most familiar? Market risk is also referred to as "volatility." This represents the day-to-day movement of an investment's value (assuming that it is traded on a daily basis). More importantly, the more volatility and risk your investment experiences, the more chance you have to grow (and shrink) your investment. It is essential for liquidity—and making people cry. Another important aspect of market risk is the likelihood of your investment following the overall direction of the market. Stocks tend to behave like other stocks. Bonds tend to behave like other bonds. Stock and bond prices are similar to a hysterical soccer game between a group of 6-year-olds. Most of the players tend to huddle around the ball, kicking madly at it. One or two players stay ahead of the game and dominate the ball. The rest of the pack follows. For instance, Bob's Hamburger Company may be doing stellar work, producing money hand over fist, but the market is down for the year and Bob's stock is following the market (not the inherent success of his company). This can be called contagion, correlation, etc.

Inflation Risk

This is, in many ways, the polar opposite of market risk. If you are not taking market risk, you are taking inflationary risk. Inflation risk is simply the chance that inflation will rise faster than your investment returns. You have to choose between market risk and inflation risk or find some balance between those risks.

Interest Rate Risk

This is the risk that you are holding bonds (sometimes called "fixed income investments") when interest rates rise. Many people are completely baffled by this; when I say "many people," I'm talking about me. Perhaps I should say I was completely baffled. It seemed to me that rising interest rates would be good for investors. Rising interest rates are good for the person who is sav-ing, but not for the person who has saved. Let me give you an illustration. You can lend me money at one of two rates. One rate is for 10% and the other is for 7%. Both loans are for $100. Which would you like? Of course, everyone wants the 10% rate. More importantly, what happens if you want your money back and intend to sell the loan? If you made the loan for 10% and then interest rates fell, it would be easy to sell! You could probably get more than the $100 you initially lent to me. Your 10% loan is more valuable because other lenders can't get that return. Now imagine the flip version. You lend me money at 7% (because it is the best deal at the time), and the next day rates rise to 10%. Nuts. Now you, the person who lent me money, has a rate of return that isn't as valuable as all those new, shiny loans being sold. Voila! Interest rate risk understood!

There are a number of risks in investing, these are just a few and some of the most important to note in the current market environment.

Most people look at this information and start to realize that investing isn't just a matter of choosing the next Amazon or Tesla. In many ways, it is like building a house. However, people typically start with buying all the supplies and realizing they don't have a plan. So, how do you create a plan?

The process is relatively straightforward, however many don't want to go through all the work. Some people want help. Families can also feel intimidated and, if one thing is certain, you want to minimize emotions while creating a plan.

Conclusion

Here are four steps to take:

1. **Identify financial goals.** Determine the time you have to accomplish the goals, the cost of the goals, and the frequency of the cost (one time, monthly, annually, once every decade, etc.). Money is a means to an end and we don't want to be comparing ourselves to the Joneses. We just want to know if we are accomplishing what we set out to do! Think about travel, hobbies, giving, retirement, etc.

2. **Identify the tools at your disposal.** Look at your existing savings, investments, how much time you have to save, your income(s), and expected returns.

3. **Identify your obstacles.** Consider your expenses, taxes, debt, aversion to risk, fees, risk specific to your situation, and inflation.

4. **Combine your goals, your tools, and your obstacles.** As time marches on, you save money, pay off debt, and investments grow, does it appear you'll have enough to accomplish your goals? If you do this yourself, get a second opinion from a trusted advisor. This can be CPAs, trust attorneys, tax advisors, investment advisors, etc. Alternatively, if you have a fantastically wealthy friend, they could be a good sounding board. As you accumulate more wealth, your responsibility toward financial management increases. You become more adept at money matters.

More questions?

Reach out to us. Finances and investments can be complicated, if you have any questions or would like to discuss your specific scenario, give us a call at **(844) 4 OAKLEAF (462-5532)** or email me at **seichler@standingoakadvisors.com**.