Investment Pitfall #1: Not Having an Investment Philosophy

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Keith: Welcome to episode three of the Empowered Investor. My name is Keith Matthews and I'm joined by my co-host Marcelo Taboada for today's show. In today's show, we will discuss the following: the biggest investment mistake any investor can make—not having an investment philosophy. We'll elaborate on why having an investment philosophy means so much and why having one is crucial for investors' long-term success. We'll also highlight outcomes investors may face if they fail to have an investment philosophy. Marcelo, we called it the biggest investment mistake investors can make. What is an investment mistake? Let's start with that.

Marcelo: Sure, Keith. So an investment mistake is a deliberate action which turns into a misstep that can sabotage your portfolio and jeopardize your long-term financial security. Some examples of that—this is an investing podcast at the end of the day—are not properly diversifying when you fall into having way too many random things in your portfolio, timing the market, building portfolios based on predictions. Some investors will be chasing performance, like what are the best stocks, and going after them. And then the biggest one, which is the one we're talking about today, is not having an investment philosophy. Now, these are all mistakes. Why are we talking about mistakes here, Keith? This is an investing podcast at the end of the day, right?

Keith: It's interesting. I guess we could just talk about the positive things to do and the positive actions investors can take in order to increase the odds of long-term success. But one of the biggest challenges of investing is not so much understanding what your game plan should be, but it's being able to block out and stop mistakes from occurring. It's one of those games where the winner can be the person that makes the least amount of mistakes.

Marcelo: Yeah, that's a good way to put it, which is why in the last show we spoke so much about noise and why noise, and in this show we'll say why noise invariably leads to making mistakes. And this, to me, is the largest investment mistake that individuals make, and it's the most basic, which is not having a philosophy, not having a game plan.

Keith: And why do these investment mistakes occur?

Marcelo: I think twofold. One is sheer lack of awareness from investors. In other words, they actually may not think that they need to have a philosophy. They may have been brought up to think, "I'm just supposed to be looking for great opportunities all the time." And the word opportunities and philosophy don't necessarily fit all the time. So I think it's a lack of awareness that an investment philosophy is needed. And secondly, we've talked about this before, we're so incredibly influenced by noise. So Marcelo, we spoke last week about noise. Give us a few examples of noise, and then we can continue on the mistakes.

Marcelo: Absolutely. That's a great point. As we talked about noise, there's many sources of noise, as you can recall. So the first one will be the most common one, which is the one we're all exposed to—it's the media, right? Newspapers, television channels, business networks—we're all exposed to them. It's inevitable. The second one would be industry noise. This is experts, economists who have a narrative about a prediction, and that typically is wrapped in a call to action. So this economy will do well, move your portfolio here, or something similar to that. Another one will be friends and family. That one for sure we're all exposed to as well. This is—think about the family dinner where you encounter your brother-in-law who made a killing in a few weed stocks. And we talked about this, right? People will tell you about their winners, their talkers—they love to share when they did well, but probably won't tell you when they did poorly in an investment. Once you have those three coming at you, which is typically what happens, those three things would combine and create internal noise in the person that will turn out into being its emotions, its stress, its anxiety, and those things can lead to inaction or mistakes on the part of the investor.

Keith: Is it fair to say that noise then leads to mistakes and mistakes can be made by both novice and advanced investors?

Marcelo: Oh yeah, everybody is susceptible. We know this for a fact. The DIY investor professionals, even the considered geniuses of investing, have made mistakes. So everybody's prone.

Keith: And what ends up happening to investors when they do make mistakes?

Marcelo: Ultimately, we talked about the most important thing for people is financial security, knowing that they're going to be financially secure forever. And that's when you make these mistakes, you end up jeopardizing this financial security, which is not what you want.

Keith: So we're going to focus in on what we think is the number one mistake, which is not having an investment philosophy. So Marcelo, how would you define an investment philosophy and why should investors care about it?

Marcelo: I think the definition of an investment philosophy is a set of principles or guidelines to steer the decision-making process of an investor and stipulate how your money will be managed across both good and challenging times. Now, this is a really important point because it's easy to have and say you have an investment philosophy when markets are good, but when markets are bad, it's really easy to just steer away and drop your plan. You can think of this as a game plan or a strategy. All successful organizations have strategies and plans to follow in good and bad times. So it's that, it's having a plan, it's having a guideline, it's having a compass of how to navigate the market environment. That's what an investment philosophy will do for you.

Keith: Yeah. And I also think of it as simply a strategy that will help you get better results and help you navigate adversities. These philosophies don't matter whether you're running a sports organization, whether you're running a business, a charitable organization that works investing. Everybody needs to have a philosophy to get the best results. So Keith, what should be in an investment philosophy?

Keith: I think at the core, essentially, it's a set of rules. It's a set of guidelines, and the rules and guidelines allow individuals to make better decisions and how to act. It shows us how to act. So there's probably five or six different components within an investment philosophy. The first component would be determining the investment style. And that means for fixed income or equities, determining the security selection. So there's a group of different types of philosophies that our listeners may have heard about. There's value investing, there's fundamental investing, there's growth investing, socially responsible investing, and even technical investing. All of these strategies are based on stock picking, trying to identify winners and holding on to those winners for long-term success. The last philosophy, index investing, is where you are capturing the entire universe of securities within that asset class, and you're letting the markets work for you. We will discuss this in much greater detail later in the show, but these are five or six classic styles of starting philosophies. There has to be, within the overall philosophy, a decision on how to diversify. Do you keep portfolios concentrated? Do you embrace diversification? You need to have a rule on how to invest your new money, how to invest your new money that you add into your portfolio. You need a rule on how to rebalance your money when portfolios get a little bit out of whack relative to policy. You need to have guidelines about how to reset the diversification. There needs to be rules on how to manage money during good times. When markets are appreciating, how do you manage money? When markets are going through difficult adverse times, like today, you need to have rules around how to manage money during those bear markets. So Marcelo, those are some classic portfolio philosophy approaches and comments. Can you give us some examples about rules in life just in general and how our listeners can grasp that and compare to rules within a portfolio?

Marcelo: That's a great question. If you think about human beings, it's fair to say that we crave order. We crave having a set of rules. If you look at the earliest religions, just look at the Judeo-Christian tradition. One of the best examples would be the Ten Commandments. It's just ten rules to live by. And every religion will have this set of rules and set of conducts, right? It almost sounds counterintuitive because "Thou shall not kill"—it's almost, okay, it's common sense, but it almost had to be set and put in stone by someone for people to adhere to these rules, right? Also, if you think about society in general, if we don't have order, it can be very chaotic, like just the wild west. Think about this theory of the social contract was developed in the 17th and 16th centuries by three philosophers: Hobbes, John Locke, and Rousseau. And this whole idea of, if you look at the state of nature, it's—in the words of Thomas Hobbes—in this state, human beings live a life that is nasty, brutish, short, but could be averted by a strong rule-based government and a government that's undivided. Now, the ideas of constitutions come into play there, where you have a set of rules of how society should act. So the main argument of the social contract is that individuals come into the social contract in order to have a better life. Essentially, you can have private property, you can have an unbiased judge, the rule of law—all these ideas come from the fact that we want order, and it's impossible to have a flourishing society or capitalism to flourish if you don't have a set of rules. These ideas of us wanting order and wanting a guideline of how to live are ingrained in our DNAs. It's why we're here today.

Keith: Did you ever think that when you were taking your philosophy and your history courses ten years ago at university, Marcelo, that we'd be sitting here using it in a financial podcast today?

Marcelo: They say philosophy is the study of life. But no, to ask you a question, I would have never thought we would be doing this. But these ideas are all-encompassing, and just like having an investment philosophy is, I think investors will appreciate just in the same way as citizens we appreciate having a constitution, the rule of law, I think an investor can benefit in the same way from having this order in their investment process. Otherwise, you're living in the wild west in your portfolio, right?

Keith: There's times in life when you want order, and there's times in life when you want freedom, and you want to be able to be creative and let loose. Imagine, Marcelo, if you and your buddies are having a party on a Friday night and you got a whole set of guidelines and rules to follow and you got to sign in and check in as you go into a party. That's not going to be a lot of fun. But investing, taking care of your nest egg, making sure that your nest egg lasts, making sure that it's there for your financial security is one of those areas. You need to have some rules and you need to have some guidelines. And when you go back to the sort of six or seven steps of an investment philosophy, you need to take that investment philosophy and then you need to bring it into an individual's personal financial affairs. And that means checking out things like what has to link with their goals, their short-term, their medium and their long-term goals. The philosophy has to link to their investment horizon. Are they an investor for seven years or are they an investor for 30 years? It has to link to their emotional ability and their financial capacity to bear risk. So when markets are volatile, that philosophy has to resonate and it has to work with the person's financial conditions. So let's assume that an investor embraces an investment philosophy. What will a well-defined investment philosophy give you?

Marcelo: I think most importantly, the biggest thing that it will give an investor is it's an antidote to noise. It's the best defense against the noise that we discussed in the last episode, which comes in four forms, right? Then it would also give you a lot of advantages, such as better investment results. Who doesn't want that? Added clarity, more control, the peace of mind of having a game plan. I think it's a huge plus. It's almost, once you have this process in place, you can navigate things in a way that reduces stress, and you know where you're going, you know where things are placed. You enter a game and you know which rules you're playing by, which is huge for people.

Keith: Yeah. And I think of it almost as a double positive. The first positive would be you get better investment results. By having a crafted plan, your actual rates of return over long periods of time will be better. Your levels of risk management will be better. So you get better results. And at the same time, you also get better emotional stability, less stress. It's a double positive. It's not often in life where you see opportunities that are—I wouldn't call them no-brainers—but there's just so many positives that come with it.

Marcelo: We talked about the benefits and they're amazing, right? So let me ask you, what are the consequences of not having an investment philosophy?

Keith: We've seen it over the years. Investors that don't have investment philosophies have two things going on. They have a portfolio filled with random ideas and investments that looks like individual securities that don't fit in with the overall portfolio strategy. It looks like sectors. You ask, why do you have that there in your portfolio? It could be specialty mutual funds. It could be a whole bunch of baggage that's stuck in a portfolio. Think of it as like, we discussed, random ideas. And then secondly, and even more harmful, are random actions, random decisions around when to buy and sell, random decisions around why you're buying and selling. So you end up moving portfolios around at the wrong time. You end up chasing fads at the wrong time. Those are the easy, observable observations as to what happens when you don't have a philosophy. And then internally, I think investors, if you ask a person, why are you unhappy with your portfolio? Sometimes they can't really put a finger to it. They can't really identify it. But the more you ask, the more they say, "I don't seem to have a plan, and I'm confused and frustrated because of that. I just don't feel confident that my portfolio is working as well as it should be." So in the end, it's like the opposite of having a philosophy. You end up with a double negative. If you don't have a philosophy, you end up with worse results, which isn't fun to live through. And then you end up with worse feelings around those results, more anxiety, which isn't fun. And so you don't really win by not having an investment philosophy. This is why we've labeled this as the number one mistake investors make.

Marcelo: In terms of an analogy, if you're playing baseball and you're just swinging at any pitch that comes your way, you'll hit that home run maybe once in a while, but it's not a consistent plan. For anybody who follows baseball, patience at the plate is what really makes the difference for a good hitter.

Keith: Yeah, absolutely. That's a great example.

Marcelo: Let's talk about the current environment, Keith. What we're living right now, right? The coronavirus outbreak. If you don't have an investment philosophy and you're going through all this volatility and all these things that are caused by the coronavirus, not only health-wise but in terms of your portfolio, which is what we're talking about here, how would that look like if you don't have an investment philosophy?

Keith: I think two things end up happening as you try to navigate very challenging times without a philosophy. A, you make mistakes in the portfolio. We'll talk about those in a sec. And then, you don't feel confident that you're going to ever see the sunshine again. And it gets very doom and gloomy. But first, let's talk about the actual mistakes that investors make. And there's two types of mistakes. One is, individuals have a tendency of bailing and abandoning their plan and moving out of the market. Now Marcelo, you got a great example of what's just happened.

Marcelo: Yeah, and you remember that last episode we discussed about that chart of 2008 when the market was at the bottom. We saw a lot of outflows of people selling their mutual funds and leaving the market at the worst possible time. So Morningstar came up with a report last week, and just in the month of March, the outflows of people redeeming or selling their mutual funds and ETFs and moving out of the market was $326 billion for the month of March. Just to give you some context, the record in 2008 of monthly outflows was $104 billion. So that's three times what we saw in the month of March. We're seeing the exact same behavior as we saw in 2008 and probably what we saw in any other crisis. It's pretty clear, and again, a lot of people maybe are withdrawing funds because they've lost their jobs. But if I was a betting man again, I would say that it's mostly people panicking and doing the wrong thing at the wrong time.

Keith: And not having a game plan for managing money throughout challenging environments. That's a market timing issue or abandoning your strategy issue. There are other issues too, like chasing. And I've seen this over multiple corrections. Individuals chase securities, styles, trends, and they jump off of their current plan and they move on to the next asset class that's doing really well. And they do that in market volatility, and that can be extremely dangerous. And I recall even 2007, 2008, the market started declining in early 2007, and it took a real fall in the fall of 2008. For that entire period from '07 to middle of '08, when the stock market generally was going down, oil, of all things back then—and I know it's hard to think about that—but oil was on fire. You had a lot of people talking about peak oil as we were going into a recession last time in 2007. They're talking about peak oil. Funny enough, compared to the negative oil prices we just slipped into yesterday. The peak oil concept was this idea that we are going to actually run out of supply and there will be no more oil. And so oil must go to $200. This is happening just as the market was, and people were getting speculative, and they were jumping, and they were moving, and they were trying to buy things as things are moving up. Right now, you have other securities in today's environment that are doing really well. The social distancing stocks are doing really well, whether it be Netflix, Zoom, Amazon, and all the grocery stores, the Loblaws and the Metros. And we're not saying that you shouldn't own those in your portfolio. You most definitely should. These are great companies. But you can't be speculating. You can't be moving portfolios around dramatically during these volatile periods because you're going to end up buying things at the high. And then when things reestablish themselves a year or two from now, you'll be disappointed with your results. Those are the two big errors, I think, that people succumb to in really stressful market conditions. One is bailing, selling at the wrong time completely, and going to cash. And the other one is actually moving things around in a portfolio and trying to catch these waves, and they'll get on a wave that might last for a couple of months, and then in a year or two from now, they'll be disappointed with the wave they got themselves on. And without an investment philosophy, you can find yourself falling prey to these two types of behaviors.

Marcelo: At the end of the day, if you have that investment philosophy, it gives you the rules and the guidelines of how to act in these situations. And if you have those, it's easier to just stick to the plan.

Keith: Absolutely. For sure. As we start wrapping things up here, how does an investor identify and adopt the right investment philosophy or an investment philosophy?

Marcelo: I think the first thing is, just like with noise, it's through increased education and awareness. And you've got to look at what the principles and the rules you're going to follow are. What is it that you're going to do when things are good and things are bad? You have to start by defining those. And how do you get to that? Obviously, you have to do your research. It has to be based on evidence. It has to be based on things that work. You can't engage in something that doesn't work. And we'll get into the details of that later. And once you have those things, I think it's an ongoing process because evidence evolves over time. We use an investment philosophy called evidence-based investing, which we'll have an entire episode dedicated to. But I think those are the three things: looking at the evidence, defining what the rules and guides will be, and increased education and awareness.

Keith: Yeah. And if there's one thing I'd love for the listeners to do is think a bit and ask yourself, "Do I have an investment philosophy? Does the firm I work with have an investment philosophy? Can I articulate that philosophy? Do I understand what it is? If a friend was to ask me, can you tell me in two sentences what the investment philosophy is? Could I respond properly? And am I confident, A, that I have one, and B, that I'm sticking to it?"

Marcelo: Yeah. And I think a lot of people who we see come through the door the first time, they think they do have one. But once you have to go through the listings of what we discussed in the episode, they won't have one. It'll be really hard to define it.

Keith: So Marcelo, what's in store for the next episode?

Marcelo: In our next episode, we'll continue our series on investment mistakes, and the show will be on why not to build an investment portfolio based on investment predictions. That's a big one. So thank you, folks, for tuning into episode three of the Empowered Investor. Please be well and be safe, and we look forward to seeing you in two weeks from now. Goodbye, everybody.

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