Investing: How Depends on Why

When it comes to investing, the *how* depends on the *why*.

Many people ask questions like "*Is now a good time to invest*?" or, in some form, "*What is the best investment*?"

There is a saying that goes something like, "*The best time to invest was 20 years ago. The second-best time is now*."

As for the second question, if I knew that answer, I wouldn't be writing this post. But what I can do is give you guidance on ***how*** you should be investing if I understand ***why*** you are investing in the first place.

One of the reasons we need to know your why is that we need to know ***how much*** and ***when*** you will need it. As a result of knowing this, we can begin to develop an understanding of how much and what types of risk you can accept.

Let's first understand the types of risk as they relate to the purpose of your investments.

Inflation Risk - This is the possibility you lose purchasing power over time due to inflation. This is why ***avoiding the market*** by hiding in cash ***may not be as safe*** as you think it is.

Credit Risk - This is the possibility a company, government, or municipality you loan money to in the form of a bond is ***unable to pay you back***.

Market Risk - This is the possibility a company you purchase ownership of through equity markets is ***worth less*** or ***worthless*** when you are ready to sell.

Unsystematic Risk - This is the risk involved with a ***specific company*** or ***industry***. You can reduce unsystematic risk through ***diversification***.

Systematic Risk - This is the risk involved with the entire financial system. You ***cannot reduce*** the systematic risk of your investments.

You cannot avoid risk, but you can choose how much of each type you are willing to accept. So, how do you choose?

If you are planning on using the money as a home down payment, losing purchasing power to inflation over six months is not going to derail you. But if you needed to sell stocks early this Spring, it may have.

When you need the money in 20 years for retirement, the stock market fluctuations matter less to you (assuming it doesn't cause you to make impulse decisions). The time the value of the account matters most is when you need to take money out. So, in this instance, you can accept more market risk in exchange for a high ***probability*** of a greater investment return compared to cash or bonds.

Emphasis on ***probability***. If we look at how often cash (One-Month T-Bills) or bonds (Long-Term US Treasuries) outperform stocks (S&P 500) even over extended periods of time, we will see it does happen. However, you will notice the longer the time frame, the higher the *probability* stocks will outperform. Of course, past performance does not guarantee future results.

How Often Does Cash Beat Stocks?	
1 Month	40.3%
1 Year	29.5%
3 Years	23.3%
5 Years	22.9%
10 Years	14.9%
20 Years	0.0%
30 Years	0.0%
40 Years	0.0%

Source: Returns 2.0

Rolling monthly returns: 1926-2020

How Often Do Long-Term Bonds Beat Stocks?	
1 Month	43.0%
1 Year	37.5%
3 Years	30.4%
5 Years	27.8%
10 Years	17.1%
20 Years	8.7%
30 Years	0.8%
40 Years	0.3%

Source: Returns 2.0

Rolling monthly returns: 1926-2020

The easiest way to reduce your risk is to diversify your investments. It may be probable that stocks will outperform over the next 20 years, but that doesn't mean having all your eggs in that basket is the best approach.

As human beings, we are wired to make poor money decisions. It’s easy for us to understand these concepts in periods of normalcy, but how about when your account was dropping sharply nearly all of this March?

Daniel Kahneman's book, *Thinking, Fast and Slow* talks about how we are wired to fear loss more than we appreciate gain. In periods of sudden stress, we can experience fight or flight and make impulse decisions. This was meant to protect us from danger back in the Stone Age.

This part of the brain is called the amygdala; it is the *fast* part of our brain responsible for memory consolidation, fear, and emotional responses. I don't need to tell you that emotion and money don't mix well.

When we are making decisions around money, we want to be using our frontal lobe, which is the *slow* part of our brain responsible for planning, organization, and logical reasoning. It's easy to use the frontal lobe in a relatively normal period of time, but how do we access this *slow*, logical part of our brains when we are stressed?

What is 3x4? You answered that pretty quickly, right? Remember, the amygdala is also responsible for memory consolidation, turning things learned into long term memory.

What is 742x76? You can probably do the math on a mental piece of paper in your head, but you needed to access the *slow*, logical part to answer that problem.

How can you use this information? If you feel compelled to do something because you are experiencing fear of loss, try playing out a multi-step scenario before you make your decision. I would encourage you to think in terms of probabilities. Here's what this may have looked like back in March:

How is this virus going to impact the economy?

What is the probability this will be permanent?

What is the probability that the virus’s negative impact will decline at some point in the future?

If I sell now, what is my signal to buy back in?

What is the probability I can time this in my favor?

If the market goes above the price I sold at, at what point am I willing to be *"wrong"* by buying back in at a higher price?

By going through a simple mental exercise like that, you can begin to think more logically about the situation. Maybe you arrive at a place to move 10% of your stocks to a theoretically safer investment like bonds or cash. Maybe you miss out on some gains. That's a whole lot better than selling all your stocks in March and seeing the market recover so quickly with no plan. You know markets don't go straight up, so don't turn an inevitable downturn into an unrecoverable loss.

Asset allocation is not the only important piece. Your planning around ***asset location*** should be thoughtfully constructed.

Certain account types offer tax benefits. Depending on your situation, a tax deduction may be worth more now than a tax-free withdrawal later or vice versa. Some accounts like 529 plans and HSAs can offer tax benefits on the way in and the way out.

Once you know the benefits of different account types, you can begin to match up which vehicles to use to get to each destination. In each additional vehicle, you can have an investment mix designed for that specific goal.

You can see how knowing ***why*** you are investing is a prerequisite for knowing ***how*** you should be investing. It's not as simple as saying that if you're 35, you should invest this way.

Finding the right account types and investment mix based on your goals and the ability to handle market fluctuations will lead to better outcomes. If you aren't sure how, it could be worthwhile to reach out to a CERTIFIED FINANCIAL PLANNER™ practitioner for guidance and clarity.

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