



Financial Fables

“It’s the Process, Stupid!”

You may have noticed last quarter that I changed the name of my newsletter to “Uncertain Times.” The newsletter is called Uncertain Times, not because I believe we are living in unusually troubling times, but to remind my clients and readers that we live in an uncertain world. This is particularly disturbing because we usually prefer certainty over uncertainty, especially when making important decisions.

Because of this uncertainty it is difficult, if not impossible, to know in advance what is the “right” choice, so we have to make a “prudent” choice. As we state in our company motto, “Because you can’t always be right, you must be prudent.”

Attempting to make the “right” choice usually involves some kind of forecasting. While forecasting weather has become more predictable with the help of weather satellites and other modern marvels, economic forecasting has not improved with technology. It is true that there is far more information available but because it is so widely distributed it is harder than ever to find hidden treasures. In addition, markets are not only affected by facts, but also by investors’ emotional responses to real or perceived facts. These emotional responses cause sudden swings in markets that are impossible to predict, and therefore impossible to time. Finally, there is the cruelty of mathematics, losses have a bigger impact than gains, so you have to be right significantly more often than you are wrong. The statistics, I have seen, show that an investor who attempts to avoid down markets by getting out in time and take advantage of up markets by getting back in at the right time, must be right from 67% to 82% of the time just to break even compared to the disciplined investor who buys into the market and holds his position.

Because prudence recognizes the limitations of forecasting, it relies on following the “right” process instead of trying to guess the “right” choice. Just as scientists use the “scientific method” as a process for experimentation, we use the “prudent process” outlined in the Uniform Prudent Investor Act as our guide for making investment decisions. While the purpose of the Act is to regulate the investment responsibilities of trustees, it is a great guide for establishing a prudent investment process for all investors.

According to the Act, a prudent process begins with risk and return objectives being defined and reasonably suited to the situation. An investment strategy can then be established considering the purposes, terms, distribution requirements, and other circumstances of the investor. The implementation of the strategy requires the exercise of reasonable care, skill, and caution. It also requires the knowledge of basic economic concepts which mandate that individual assets are evaluated in the context of the investment portfolio as a whole, that the portfolio is well diversified, and that cost and taxes are kept low.

Fear and greed are powerful emotions that tempt us to believe that forecasts can reduce the risk of uncertainty. However, following a prudent process is a much better way to handle economic uncertainty. The drafters of the Uniform Prudent Investor Act remind us that “the standard of prudence is not outcome but process.” Or as a good friend keeps reminding me, “It’s the process, stupid!”