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The Rules of Prudent Investing

Overview: Some of the most complex problems investors face can be solved with simple solutions. The following rules may help investors build and adhere to a well-designed investment plan.

While we search for the answers to the complex problem of how to live a longer life, there are simple solutions that can have a dramatic impact. For example, it would be hard to find better advice on living longer than the following: do not smoke; drink alcohol in moderation; eat a hearty breakfast and follow a balanced diet; get at least a half an hour of aerobic exercise three to four times a week; and buckle up before driving. The idea that complex problems can have simple solutions is not limited to the question of living a longer life.

The following investing guidelines may be instrumental in giving investors the best chance of achieving their financial goals.

Constructing an Investment Plan

- **Do not take more risk than ability, willingness or need dictates.** Plans fail because investors take excessive risks. The risks unexpectedly show up and the plan is abandoned. When developing a plan, investors should consider their investment horizon, stability of income, ability to tolerate losses and the required rate of return.
- **Never invest in any security without fully understanding the nature of all of the risks.** If investors cannot explain the risks to their friends, they should not invest. Fortunes have been lost because people did not understand the nature of the risks they were taking.
- **A well-designed plan is necessary for successful investing.** What else is needed? The discipline to stay the course, rebalance and harvest tax losses as needed.
- **A well-designed investment plan has many elements.** It should be integrated into a well-designed estate, tax and risk management (insurance of all kinds) plan.
- **Do not treat the highly improbable as impossible, nor the highly likely as certain.** Investors assume that if their horizon is long enough, there is little or no risk. The result is they take too much risk. Taking too much risk causes investors with long horizons to become short-term investors. Stocks are risky no matter the horizon.
- **The consequences of decisions should dominate the probability of outcomes.** Investors should ask themselves if they can live with the outcome, regardless of how small of a chance there is of the outcome occurring.
- **Avoid working with commission-based advisors.** Commissions create the potential for biased advice.

- **Only work with advisors who will provide a fiduciary standard of care.** That is the only way to ensure that the advice provided is in the investors' best interest. There is no reason not to insist on a fiduciary standard.
- **Separate the services of financial advisors, money managers, custodians and trustees**. This minimizes the risk of fraud.
- **A strategy is either right or wrong before the outcome.** In general, lucky fools do not have any idea that they are lucky. Even well-designed plans can fail because risk (that was deemed acceptable) shows up.
- **Hope is not an investment strategy**. Investment decisions should be based on the evidence from peer-reviewed academic journals.

Maintaining an Investment Plan

- **The more complex the investment, the faster investors should run**. Complex products are designed to be sold, not bought. Investors can be sure the complexity is designed to favor the issuer, not the investor. Investment firms do not simply give away higher returns.
- **Risk and return are not necessarily related. Risk and *expected* return are related.** If there is no risk, there would not be higher expected returns.
- **Securities with high yields have high risks, even if they are not apparent.** Investors should never confuse yield with expected return. Just as Snow White could not see the poison inside the apple, investment risks may be hidden, but you can be sure they are there.
- **The only thing worse than having to pay taxes is not having to pay them.** The "too-many-eggs-in-one-basket" problem often results from holding a large amount of stock with a low cost basis. Large fortunes have been lost because of the refusal to pay taxes.
- **The safest port in a sea of uncertainty is diversification.** Portfolios should include allocations to the asset classes of large-cap and small-cap stocks, value and growth stocks, real estate, international developed markets, emerging markets, commodities and the appropriate amount of bonds.
- **Diversification is always working. Sometimes investors like the results, sometimes they don't.** Diversification reduces risk without reducing expected returns. Once investors diversify beyond popular indexes (such as the S&P 500 Index), they will be faced with periods when popular benchmark indexes outperform their portfolio. The noise of the media will test their ability to adhere to their strategy.
- **The correlation of risky assets tends to rise toward one during crises.** Investment plans should account for this.
- **Identifying a mispriced security is necessary to outperform the market. What expenses are associated with trying to find the mispricing?** Many investors have tried to exploit mispricings, only to find that trading (and other) costs exceeded any benefits.
- **Equity investing is a positive sum game. Expenses make outperforming the market a negative sum game.** Prudent investors do not play negative sum games unless they can identify a distinct advantage, sufficient to overcome the costs of playing. Use only low-cost, tax-efficient and passively managed investments.
- **Owning individual stocks and sector funds is more like speculating than investing.** The market compensates investors for risks that cannot be diversified away, such as the risk of investing in stocks versus bonds. Investors should not expect compensation for diversifiable risk, such as the unique risk related to owning one stock or sector fund. Prudent investors only accept risk for which they are compensated with higher expected returns.

- **Take risk with equities.** The role of bonds is to provide the anchor to the portfolio, reducing overall portfolio risk to the appropriate level.
- **Before acting on seemingly valuable information, investors should ask themselves why they believe that information is not already incorporated into prices.** Only *incremental* insight has value. Capturing *incremental* insight is difficult because there are so many smart, highly motivated analysts doing the same research. Recommendations on CNBC, from a broker or *Barron's* is already known by the market. It has no value.

Staying the Course

- **The strategy to get rich is entirely different than the strategy to stay rich.** One gets rich through inheritance or by taking risk. One stays rich by minimizing risk, diversifying and not spending too much.
- **The four most dangerous investment words are "This time, it's different."** Getting caught up in the mania of the "new thing" is why the surest way to create a small fortune after starting out with a large one.
- **The market can remain irrational longer than you can remain solvent.** Bubbles occur. However, investors should never attempt to short them because, while bubbles eventually burst, they can grow larger and last longer than investor resources.
- **If it sounds too good to be true, it probably is.** When money meets experience, the experience gets the money and the money gets the experience. The only free lunch in investing is diversification.
- **Keep a diary of market predictions.** After a while, investors will likely conclude that they should not act on their "insights."
- **Good advice does not have to be expensive, but bad advice always costs dearly no matter how little is paid for it.** Smart people do not simply choose services based on cost (the cheapest doctor or CPA). Costs matter; but it is the value added relative to the cost of the advice that ultimately matters.

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