Chapter 2: Truth versus Clarity

Welcome to the most recent installment of **A Guide to Sleep-at-Night Investing in an Uncertain World**, a series of the Keep Calm and Carry On Investing podcast. I am your host, Daniel Peris. This episode is called Truth vs. Clarity. There is almost no practical discussion of investing in it, but I believe that it is perhaps the most important episode of this entire enterprise. It's where, I hope, you determine your expectations and your approach to investing, where you set your priorities. Let me give you a few examples from other realms: when you buy a house, is it absolutely perfect? Does is check all the boxes of location, size, cost, amenities, style, neighborhood, neighbors, sunlight, etc? Probably not. But you make a choice because it ticks the boxes that are most important to you. And you are unlikely to move six months later because of its minor shortcomings. Same with a job, a college, a spouse.

Knowledge of the market is a very good thing; but self-knowledge is even better. It's what let's you sleep at night. That's the goal of this podcast. Polonius may have been a long-winded fool, but his "to thine own self be true" was perhaps Shakespeare's best advice in regard to investing, and pretty much everything else. I'm sure that if you scrape through Ben Graham's work or Warren Buffett's commentaries, I can find a similar quote about self-knowledge.

The timing for this exercise in self-knowledge—what I call here Clarity—could not be better. 2020 has been a head-scratching year from a stock market perspective. We saw record highs at the beginning of the years, a sharp Covid sell off, and an equally sharp recovery during the summer. The FAANGS and their ilk sold off again in early September 2020, and then quickly recovered to prior valuation levels. A new wave of sit-at-home small traders is expressing their opinion through Robinhood. Huge bets are being made, in opposite directions, on inflation, on interest rates, on earnings, on the market. And yes, there's a presidential election. So in short, it is a chaotic time.

That makes it even more important, albeit harder, to know exactly what you want. So let's start with a basic question, one that you should ask yourself or get answered as part of your discussion with your financial advisor? What do you want from your stock market investing dollars? You'd think that it is a simple question and answer, but really it isn't.

Is it a number? A certain level of assets that you are aiming for? Is it $1 million or $2 million or 5. That's certainly one option. Another option: Is it an expected amount of income on an annual or monthly basis to help you pay your bills? $3k a month, $5k a month? More? Is it to have a total return of a certain percent annually, say 10% or 15% or 20%? Is it to beat the "market,", and if so, how do you measure that?

Is it, to cite the old brokerage add, "to be bullish on America," to own stakes in innovative companies, say Social Media or BioTechs, without much worry about valuation or cashflows. That's a valid choice too.

At the other end of the spectrum of goals, is your goal capital preservation and just preservation of capital?

Is it a target date exercise, to have a certain amount at a particular time to purchase a property or pay for a child's or grandchild's education? Is it to have enough to retire to Florida, to sail around the world, once that again becomes possible? Perhaps it is a combination of all of the above? Is it perhaps a more general goal "to do well" and leave that undefined? Is it to have "Peace of Mind?" That's my personal goal, by the way; that's what let's me sleep at night.

Or let's define the challenge in another way? Your investing goals may be whatever they are, but what about the risk you need to take to achieve them? Life involves risk; business involves risk; investing involves risk. When you speak to an investment advisor, he or she will mechanically determine your risk level? Is it low, moderate, aggressive, etc. and how do they define those terms? Is it risk in terms of the income stream, in terms of the capital, in terms of the total return? Those are all different, by the way. And over what time period are you considering the risk? When considering and measuring risk, timing matters.

I have to look at share prices daily; you do not and should not. If you say you are considering whatever definition of risk over a period of years, are your really? And are you using your definition of risk or someone else's? It turns out that there are lots of real-world answers to all these questions.

Are you shocked by these questions? Surely, you are thinking, there is a simple and singular question and a simple and singular answer for both investment goals and the notion of risk. The investment industry has been around in an organized fashion for more than a century. There must be a set answer.

Well there is an official answer. It's just not a very good one. And for that reason, few people seem to follow it. In twenty years of managing money on behalf of institutions and people, this question of "what do you want," how do we measure it, and what's your notion of risk comes up over and over again with clients. Few people seem to know. And not knowing what you want—whether in investing or any other endeavor in life—creates a lot of problems when you go about the actual task of investing, or living for that matter. You have no anchor.

Still, lurking in the background, the stock market does have an answer for you, a default answer if you will, hammered out by academics. If you don't choose something for yourself, this is what you are going to get as an investment goal: Are you ready? Are you sitting down? Here it is: the maximum amount of total return for a specific amount of risk, risk being defined as a function of the standard deviation of the total return. Or, if you flip that around, you get the lowest amount of risk for a given expected total return. It can be measured daily, but it usually is assessed, say, on a monthly or a quarterly basis. Ideally it should be viewed on a multi-year period. And those measurements are generally compared to a benchmark of some sort, a style-specific benchmark or a general market one such as the S&P 500 Index.

Ta, daaaa. That's the formula. That's your investment goal and your definition of risk. Great. We're done here.

It's what I call in the context of this podcast "Truth." It is officially sanctioned by the relevant authorities—academics and to some extent even regulators. Vast systems are designed to let you know where you stand versus this search for this financial Holy Grail, this Truth.

I'm glad we got that covered. Now that you know that that is what you want, you can Keep Calm and Carry On Investing and sleep at night, right? In theory yes; in practice, probably not. For me to formally argue against this Truth, that is, focusing all your energy on maximizing risk-adjusted total return, could get me in trouble with the authorities, so I won't say that. What I will say, and can say, is that very few investors actually follow the official prescription, perhaps because it is not particularly good advice. It's a one-size-fits all handcuff, and it rarely if ever comports with what people actually want in life or from their investments.

To that point, I've almost never, if ever, heard an investor say to me, institutional or retail, that they actually want positive risk-adjusted relative return over a multi-year period. That's the short-form name for this goal. All the text books and all the training programs aim in this direction, and I'm not saying that it is not 'True"—particularly in a classroom setting—but like many truths that people seek, it's a complicated, often-oversimplified quest.

This "Truth" fails in practice on many fronts. Even its inventor, Harry Markowitz, acknowledged that it was very hard to realize in practice. But for individual investors, it fails for easy-to-see answers:

First, this truth is supposed to manifest itself over long measurement periods—no less than several years, and ideally longer. But most investors have much shorter time horizons. They say they are in the market for the long-term, commit with their financial advisor for a particular strategy—whatever it may be—but the stock market appears to go against them for a few months, they fold and change direction, usually at the wrong time, getting in at the top and out at the bottom of their particularly strategy. This "near-termism" in investment timing is a well-known problem written about by many, including myself, but it cannot be mentioned enough.

In my own case, it means having investors who swear they want income from their equities, who believe in dividend investing, who understand or say they understand the difference between investing for income and speculating in share prices, who sign on the bottom line, but ….. after the past few years in which non-dividend stocks have gone up much more than dividend-paying ones, the past few years of watching a certain electronic vehicle company dwarf the financial news and the stock market, they change their minds. They say they no longer need or want income, they just want to ride the EV wave…. C'est la vie.

It's a free country, sort of, and the capital markets are open every day. If you want to change your goal in the market, that's fine. But let's not confuse that with investing, and if it is, it is a very specific form of it: chasing the hot dot, as we say, or momentum investing, or investing in what is working right now, whatever.

Think about it. Very few important decisions in life are taken lightly and then frequently reversed. Were the first few months of college or a new job or living in a new city easy? Probably not. Did you reverse course? Also probably not. But the stock market is open every day and lets you reverse course frequently, and that is unfortunate. Business investing the way I will be describing it is a long-term proposition, and has the means—not a perfect mechanism—but the means to sidestep the near-termism that is a plague to so many investors. Knowing what you want, stating it clearly, even if it is just to be a near-term speculator, is the key to not getting whipsawed around.

The second critical failing of the "Truth" of what you are supposed to want from the stock market is in regard to risk. Anyone who has even a passing familiarity with the stock market or any business venture understands that there is risk in any endeavor. And most stock market participants will acknowledge that there is "risk" involved. But how do you define risk? I know how I define it, and it has nothing to do with the standard deviation of total return over short or even intermediate measurement periods. Later in this series, we will cover other definitions of risk, particularly those that are relevant to the business investors seeking income from the stock market.

But the greater problem is not the particular definition of risk, it's that most retail investors and plenty of institutional ones just want to beat the market in total return terms—mostly share price appreciation in short measurement periods. Period. That's their Truth. They show little concern for any definition of risk or actual risk in their analyses. They just want so-called outperformance last quarter, last year, every quarter, every year…. There's nothing---per se—wrong with that at all. Aim high. As long as investors understand what they want and how it is measured, and most importantly, that they understand that their goal and their definition of risk—or utter disregard of risk—is a choice and that there are alternatives.

A variant of that theme is to give up entirely and just index the whole market and not even make an effort to choose goals or risks. Perhaps for some investors, that is their moment of Clarity. If so, that is fine. It's not really business ownership through the stock market, and it can be extremely dangerous when only a handful of the companies dominate the market, as is the case now, but if that is your Clarity, so be it. Though it is probably safe to say that if you fall into that camp, you are not listening to this podcast.

To summarize, having your goal be that stocks go up today (the popular variant) is vastly inferior to risk-adjusted total return over 3-5 years (the industry's stated but unobserved canonical "truth"). And that truth is itself vastly inferior to your personal sleep-at-night investment Clarity.

Let's get some examples of that Clarity about investment goals. Indulge me, please, as I reach far and wide for examples of clarity. It is, ultimately, a subjective personal choice, despite the efforts of the classical economists and finance professors to frame all human choices in narrowly defined quantitative terms.

Let's start with a few examples of a subjective answer to a quantitative question. In 2005, Kurt Vonnegut penned an appreciation in the *New Yorker* for the Catch-22 novelist, Joseph Heller. In a prose poem, entitled, simply "Joe Heller," Vonnegut tells the following story:

True story, Word of Honor:

Joseph Heller, an important and funny writer
now dead, and I were at a party given by a billionaire
on Shelter Island. I said, "Joe, how does it make you feel
to know that our host only yesterday may have made more money
than your novel 'Catch-22' has earned in its entire history?"
And Joe said, "I've got something he can never have."
And I said, "What on earth could that be, Joe?"
And Joe said, "The knowledge that I've got enough."
Not bad! Rest in peace!"

That's from The New Yorker issue of May 16th, 2005. I do not have permission from either the estate of Kurt Vonnegut or the *New Yorker,* so at some personal risk, I share that wonderful vignette with you. It's message is simple. Clarity.

Staying in the literary realm, you will all be familiar with Tolstoy's famous folkloric short story, "How much land does a man need?" If you are not, it is available in translation through your local bookstore. I recommend the Calypso Editions version from 2011 that features the original Russian text side by side with a modern English translation by Boris Dralyuk. In it, a Russian peasant craving land invokes the devil, who offers him as much land as he can walk around in the course of one day, but he must return by sunset or he forfeits the land. The peasant charts a grand border before having to run back to his starting point at sunset. He arrives exhausted, only to collapse. His manservant buries him in a six-foot grave. It turns out that that was all that he needed.

A bit closer to home, Christine Benz, Director of Personal Finance at Morningstar offers a stellar example of Clarity. She cites the "This I believe" series on National Public Radio which is based on a similar radio show from the 1950s hosted by legendary newsman Edward R. Murrow. In the essays, prominent individuals discuss the core events and beliefs that have shaped their lives. As Benz writes,

"The series consistently demonstrates the value of having an overarching set of beliefs that can help you navigate tumultuous times. Think of your investment policy statement as your own, investment-related version of "This I Believe." In it, you'll articulate the key reasons why you're investing, what you're hoping to gain from your investments, whether you're on track to meet your goals, and whether any changes are in order. Once you've created one, you can use your investment policy statement as your compass, a check to keep your investment portfolio on course to meet its goals even when the market and your emotions are telling you to run for the hills. Referring to your investment policy statement before you make any investment decisions can help ensure that you're investing with your head, not your gut."[1]

This is an outstanding piece of investment advice as Clarity.

Market commentator and asset manager Barry Rittholtz has a similarly digestible version of Clarity. In a Bloomberg.com commentary from earlier this year[2], he writes, and I summarize, that:

"…You are not Warren Buffett [or Jim Simons or Bill Ackman or Howard Marks]. But here is the thing: You don't need to be. At least, you don't need to be any of these people in order to achieve the investment returns that will ensure a comfortable retirement. Your temperament is different from that of Munger or Simons or Buffett or Marks or whomever. We look at [the] fantastic wealth-creating trades [of these individuals] and waste our time wondering, Why not me? Instead, find an investment style that suits your personality, available time and interests as opposed to trying to match those with whom you have nothing in common…. Instead of trying to imitate the greats, understand your own personality."

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[1] https://library.morningstar.com/mkt/investing_for_the_long_run.pdf, 71-74, and https://www.morningstar.in/posts/20403/

[2] https://www.bloomberg.com/opinion/articles/2020-04-24/why-you-re-not-one-of-the-world-s-great-investors?sref=vBm6bz3t

In even fewer words, you have the great wisdom of George Goodman, writing as Adam Smith in the late 1960s, **“If you don’t know who you are, the stock market is an expensive place to find out.”**

It’s not too difficult to find these types of statements from wiser market observers and participants. What’s hard is making the commitment to determining your personal Clarity and then implementing it and sticking to it.

For now, however, think about what you really want from your investing dollars, and what you are willing to put up with in order to achieve it. The behavioral finance gurus will tell you that your answers to the following questions might be wrong, but asking them is a necessary part of achieving investment Clarity.

So, do you consider yourself tactical or strategic when it comes to investing? Are you patient or impatient? Are you easily distracted by the latest tidbit of news? Do you hover over the stock market day and night, or pay little attention to the market? Are you able to admit what you are good at, and what you are not good at, when it comes to designing and implementing a financial plan? What you gives you pleasure or pain in investing? Is it a dividend announcement or a “pop” in the stock. Or a quarterly “miss”? Do you have strong views, or any views, about the direction of the economy, the market or valuations.

Other questions: How well do you know your financial advisor? Do they know you well enough to align a portfolio with your personality? As you work out your plan, make sure to consult someone who knows you really well. There are lots of other questions to ask, but even those questions depend substantially on your particular personality and financial situation.

Clarity will not likely come from a brief moment of reflection. It will probably take a while to be worked out. Better start now.

How will you know when you have achieved a degree of Clarity in regard to investing in the stock market? It’s hard to say, but you will be unlikely to zig and zag in your investment choices, you will be able to tolerate near-term setbacks without worrying, without losing sleep, and you probably won’t be checking the market every single day. In short, like Supreme Court Justice Potter Stewart, “you’ll know it when you see it.”

That’s the end of this episode. Thank you for joining me. Please send in any comments or questions that you have. The next episode will be a special, out-of-order show on how academics have, in my opinion, really laid an egg in regard to investing over the past 60 years. It will be controversial. I hope you will tune in. In the meantime, Keep Calm and Carry On Investing.