4 Keys To Successful Long Term Investing

One of the greatest con's ever perpetuated in the history of man is that "you can win at the investing game." There is no historical evidence that shows that the average investor can outperform a benchmark year-in and year-out over a long period of time. Even the professionals can't do it. As a case in point Bruce Berkowitz, the famed "fund manager of the decade", who oversees the Fairholme Fund (FAIRX) suffered brutal losses on bets made on Bank America stock (BAC) and turned years of outperformance into underperformance. Today, more than ever, the game seems to be stacked against the average investor as high speed trading takes advantage of the retail investors online order flows by nanoseconds. The proprietary trading desks, who have access to massive pools of capital, can push markets on an intraday basis while computerized programs execute orders based on data flows. For the average investor who is working for a living, and only occasionally checking their investments, the deck is heavily stacked against them.

While Wall Street gets government bailouts for "bad behavior" - you don't.

This is why it is harder now, than it has ever been, to win the long term investing game. It has truly become the battle of "David and Goliath" with Wall Street armed with better technology, more resources, more information, teams of people dedicated solely to a single outcome versus - you and your computer. Who do you really think will win in the long term?
Wall Street has a huge conflict of interest with investors - they need your money flowing into their products so they can charge fees. Wall Street is a business and, for them, business is good as long as investors buy into the game that investing is the way to grow "rich." However, as investors, we must abandon the idea of chasing some random benchmark index, which really has very little to do with our own personal investing goals, and focus on the things that will make us successful long term investors.

1) Save More / Spend Less

Most individuals start out investing the wrong way - gambling. As I said - Wall Street has a vested interest in making sure that you keep plugging money into the casino. Like Vegas, Wall Street depends on "players at the poker table" for their cut. The more you play - the more money they make. Whether you win, or lose, is of no consequence to them.
For the individual who wants to have enough money to sustain their current lifestyle through retirement - the first key is to "save" money. Saving money, which requires spending less than you make, is the cornerstone for long term financial success. While this may seem obvious to most - the reality is that in today's society very few individuals actually "save" money.
Over the last 30 years the wisdom that has been lost in the financial markets is simply this: "The stock market is not meant to make rich - it is meant to KEEP you rich." The financial markets were never intended to become the giant casino that they are today. **The purpose of investing has always been to ensure that the dollars you have today maintain the same purchasing power parity in the future.** In other words your only investment goal should truly be to make sure that your "savings" are being adjusted for "inflation" over time.

2) Low Risk = Long Term Success

Risk does not equal reward. Too often I get emails with statements of "I'm young so I want to be really aggressive." This is a huge mistake. The reason is RISK is a function of how much money you will lose when you are wrong - and you will be wrong more often than you can imagine. The problem with being wrong is that the loss of principal creates a negative effect to compounding that can never be recovered. The table and chart below provides an example. The problem with following Wall Street's advice to be "all in - all the time" is that eventually you are going to dealt a bad hand. By being aggressive, and chasing market returns on the way up, the higher the market goes the greater the risk that is being built into the portfolio. Most investors routinely take on more "risk" than they realize which exposes them to greater damage when markets go through a reversion process.

These corrections, as you can see in the example above, have two very negative effects on investors. The first is that the reduction of principal keeps the portfolio from meeting its original investment objectives due to the destruction of the "compounding effect". Secondly, the commodity of "time" is forever lost. While investors will eventually be able to work themselves back to "even" after suffering a brutal loss - the time component, and the subsequent lost return on invested dollars - is forever gone.
The next time a person trots out a chart of the return of the markets over the last 100 years - just remember that you will not live that long.

3) Asset Allocation Does Matter

Today the correlation between many asset classes has never been higher. With the increases in the flow of data cut down to milliseconds the reaction of markets to news has become amplified. The days where diversification in stocks between international and domestic, capitalization and growth versus value no longer provide the lower risk profiles that could once be achieved.
In the market today it is no longer simply a choice of what stocks to buy. Rather it is the understanding of the inter-relationships between stocks, commodities, bonds, cash, alternative and private investments and the risk profiles of each.
The hypothetical allocation model above shows the expected risk profile of several different asset classes. By blending assets together, and modeling the volatility of each asset class relative to the whole portfolio, the investor should be able to generate "risk adjusted" returns over the projected investment horizon.
The term "risk adjusted" returns is critical to the reframing the mindset of expectations from the portfolio. While the media/Wall Street speak in terms of "relative performance" related to an all equity benchmark index such as the S&P 500 - for investors it is important to adjust those expectations to what the portfolio is designed to return. If we assume that the above allocation model is designed to deliver 60% of market returns during an advance, but only 40% of the declines, then expectations must be adjusted so that during a +/- 10% market movement the portfolio will deliver "risk adjusted" returns of 6% and -4% respectively.
However, while Wall Street will chasitise investors who fail to beat the benchmark index in any given year on the upside - it is avoiding the drawdowns the inures to the long term performance of the portfolio. The mitigation of losses will significantly increase the probabilities of obtaining the original investment goals.

4) Listen To The "Little" Voice

It is amazing how often I hear people tell me on my radio program, or by email, that they "wish they would have sold" or "bought" some position when they originally wanted to - but didn't for some reason or another. This is the single biggest complication for individual investors that Wall Street's computer driven algorithms do not suffer from - emotional decision making.
When I was growing up one of the best pieces of advice my father ever gave me was "Son...listen to that 'little voice' inside your head...that is your common sense talking." My father was usually right about such things. The emotions of "fear" and "greed" are deadly to individual investors over the long term. These emotions tend lead investors in doing exactly the opposite of what they should be doing which is why so many individuals consistently "buy high" and "sell low." What is interesting, however, is that when I counsel an individual and ask them why they implemented some action, more often than not, they respond with "I knew better."

Listen to that "little voice" - it is your common sense talking will likely keep you out of trouble over the long haul.

Winning The Long Game

In golf there is a saying that you "drive for show and putt for dough" meaning that it is not necessary to be able to drive a golf ball 300 yards down range - it is the putting that will win the game. In investing it is much the same - being invested in the market is one thing, however, understanding the "short game" of investing is critically important to winning the game.
Focus on managing the "risk" of the portfolio rather than chasing "returns." By minimizing the risk of loss over time the returns will come as a function of a solid asset allocation and risk management protocol. While the media, and Wall Street, focus on the daily "noise" of headlines - most investors will be significantly better off turning off the television, putting down the newspaper and focusing on the objectives of the portfolio, managing the risk, saving more and letting common sense guide investment decisions.

It is your money after all. If you do not pay attention to it - it is unlikely that anyone else with either.

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