No Easy Answers in Investments

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At investment conferences around the country, we've had the opportunity to answer many of the questions facing advisors today. This blog post highlights examples of questions that help and hinder thinking about investments. Let's pick on some questions that may be unproductive to ask because they get investors thinking like speculators: for example, what's the S&P500 (or ten year bonds or Tesla) going to be at by the end of the year?

The answer, of course, is that no one knows. When data have been collected on these predictions from the people who are willing to answer these questions, they turned out to know less than nothing; the accuracy of their predictions was less than random chance. We should admit that we don't know and move on. "Are we in a bull or bear market?" is really the same question and unfortunately just as unanswerable—a few years from now, we'll know the answer, but it won't do us much good by then.

Productive questions don't always have clear answers, but they lead to thinking about the realities for investors. For example, how should we best measure risk? The answer is not immediately clear. Sharpe ratios are noisy, and seemingly ideal investor focused statistics like upside/downside capture are highly sensitive to the time period used and too easily manipulated. This leaves us with standard deviation as the simplest, most honest, and probably the best way to compare the risk of a stock, portfolio, or investment strategy. Unfortunately, none of these directly help the investor understand how likely they are to meet their goal with this investment. And that's the risk and benchmark that investors care about.

People want to believe they know better than others. They like to think they can beat the system—in this case, the market. They want to be tactical, choosing only the best investments at precisely the right times. How often have you heard someone claiming either "Now is the time to own stocks" or the converse? The thought that the market is irrational yet you know better can be seductive. And in hindsight, picking the right investment vehicle seems so easy, the signs of success so obvious now. Who hasn't regretted missing out on Apple before the iPhone or Tesla last year? But, in reality as opposed to hindsight, the future movements of investments is never clear.

There is a timeless relationship between risk and return. It will hold over the next

decade as well as over the next day. Risk and uncertainty need to sell at a discount; therefore, they provide a higher return for those willing to accept it. At every time horizon, financial institutions can hold and lever a greater amount of less volatile assets than those with higher volatility. The market prices bonds with credit risk lower than those without. Analysts price a small company in an emerging economy with poor analyst coverage, governance, accounting standards, and history of responsibility to the shareholder less than a company that is better understood and predictable. These are some of the immutable laws of financial markets. To bet against them is betting against the house—a sure way to lose over time. To shun one asset class or broad sector in favor of another is speculation and market timing, not investing.

So there are no easy answers to the hard questions of investing. In order to fulfill our fiduciary duty, we need to understand the cold hard laws of financial markets. There are no free lunches, and the systematic way to potentially achieve higher returns than other investors is to be more patient and tolerant of risk. Don't count on luck, and don't go looking for magic elixirs.

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