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Building a Buffer

By Brian Loy, CFA, CFP
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Unless you marry or inherit wealth, most investors are going to have to do it the old fashioned way – create or earn, save and invest. The first two are relatively simple; it's the third, investing, that gives most people the greatest grief. We're navigating life's issues – emotional and behavioral issues. As much as we strive to make thoughtful, rational decisions (e.g. prudent investing), emotional and cognitive biases get in the way. Dan Ariely's book titled Predictably Irrational says it all. Let's recognize those challenges, and incorporate buffers between our emotions or behaviors, and the active process of investing.

Questionnaires to help us develop the "right" investment strategy typically contain categories such as your goals, vitals, resources, and business considerations. I'm amused with the "risk tolerance" sections, where I check the box belt-and-suspenders-guy, wing-walker, or someone in between. I'm not a licensed psychologist, but it's my experience that (1) people are generally risk averse when it comes to their financial future, and (2) the degree or level of risk aversion shifts based on how we're feeling at any given point in life.

A frequently used 'risk aversion test'… *I offer you a bet using a fair coin toss. If you lose, you give me $100. What is the minimum amount you need to win to make the bet attractive to you? $50, $100, $150, $200, $250, or some other amount?* The common answer is $150, so already the 'average' person is reluctant to take a 50/50 bet. And do you ever find yourself driving slower after seeing an accident? Imagine learning that a close friend is diagnosed with a chronic disease (please, I'm not wishing any ill will) – isn't it likely that the required 'minimum win' might shift to $250, or higher?

Today, some people would like to shift to more conservative investing (*"Brian, I don't want to go through another 20% (or more) decline"*). That's fine if you've stashed away sufficient wealth. Others may need to work longer, or stick to the written investment plan. Perhaps they're committed to their nice-to-have goals, rather than settling on need-to-have goal. Perhaps being too risk averse actually puts them at higher risk in achieving their goals (e.g. are CD returns sufficient?).

Another factor is information overload, and 'shortcuts' we tend to take to quickly make decisions. Take this problem (source: Frederick 2005) … *In a lake, there's a patch of lily pads. Everyday, the patch doubles in size. If it takes 48 days for the patch to cover the entire lake, how long would it take for the patch to cover half the lake?* Your first response might have been 24 (47 days is correct).

Take your time in making big decisions. Do we allow things to be categorized by how they appear, rather than how they statistically are – e.g. Company A is a good company; therefore they *must* be a good investment? "Star chasing" can interfere too. We all want the best in life, but the process can lead to paralysis (never making a decision), or a hapless endeavor of constantly changed minds (e.g. watching the dog chase birds at the beach).

These are challenging times. Some Americans maintain their dreams of sipping Mai Tai's on the beach. Others wish for not having to serve them. You're well advised to stick to your written investment plan (or if none exists, make it so). As Denis Waitley said "Expect the best, plan for the worst, and be prepared to be surprised."