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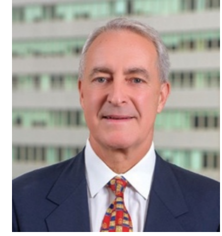

Thoughts for Investors

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Distraction

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"You look, but you do not see."
– Sherlock Holmes to Dr. Watson

As of the writing of this newsletter and despite predictions, the stock market has not collapsed. Hopefully, one of the lessons learned from the dark days of May 2009, when the Dow Jones Industrial Average (DJIA) skirted with 6000 (versus near 13,000 today), is not to be distracted from the job of investing. Distraction is the topic of this newsletter.

Today it is possible to get stories from around the world instantaneously. Whether it is a terrorist attack in Mumbai or an earthquake in Japan, we know about it moments afterwards. That is no longer amazing. What is amazing is thanks to Facebook, YouTube, Twitter, etc., we can now know the very minutia of human life just as fast. The whole world can know, in fact even see, your baby's first diaper change as it is happening. Maybe that is a good thing for faraway grandparents, yet for the world? And don't forget that every bit of data is now saved somewhere - forever. Your child will be cursing you when that diaper change video is played at her wedding.

Similar "importance" is also given to business minutia. While the amount of soap sold at Walmart this quarter may be important to Walmart (and Procter & Gamble, its manufacturer), is it important to long-term investors? If you are a high-velocity hedge fund trader, I suppose minutia is terribly important. But if you are a long-term investor, it may be just a distraction. There exists a place where all these bits of minutia, I mean data, are ingested and digested in order to, supposedly, aid in the "efficient" pricing of stocks. That's the stock market.

But what if the stock market's ingesting and digesting of all this data – from soap sales to Greek elections - is not as critical to investor returns as one would think? Does watching the stock market filter all this data, instantaneously, help or distract investors? I believe John Bogle, founder of the Vanguard Mutual Funds, is correct when he says, "The stock market is a giant distraction from the business of investing." Truthfully, investors have always been distracted by the stock market, though in the distant past only once a day when we picked up the newspaper, checked the stock pages and mentally tallied our rise or fall in net worth. Today with all kinds of performance reports and benchmarks, investment consultants, retirement planning software programs and Internet access to our accounts and to the PE ratios of every stock in the universe, investors have lots of help getting distracted. Are investor results today any better because of all this "help"? Have you noticed that while golf equipment keeps getting better, golfer's average scores remains the same? Maybe golfers should spend their time (and money) on lessons from the golf pro and not on more equipment.

"The articulate voice is more distracting than mere noise.
– Seneca

Even the revered "asset allocation" theory, in my opinion, is a distraction. I do not believe investors can "allocate" their way to investment success. To build wealth, one needs to save and then invest those savings offensively with varying degrees of risk. To preserve wealth, one needs to have wealth to begin with, and then invest it defensively as factors such as

inflation and deflation seek to erode it. As Warren Buffett says, "The best way to minimize risk is to think." In my view, it is difficult to think if one is distracted pondering over pie charts or past performance.

"You cannot be disciplined in great things and undisciplined in small things."

– General George S. Patton

What effect do all these distractions have on actual investor performance? DALBAR*, a company that studies investor behavior, found that over 20 years ended 12/31/10, the average stock mutual fund investor earned 3.83% versus a 9.14% return for the S&P 500 index. What accounts for the difference? Cost for one thing, yet cost cannot account for such a huge difference. As you may suspect, the bigger problem lies with investor behavior. Investors often feel compelled to react to every distraction. "I'm nervous and things don't look so good with the world and the economy right now so I will get out and get back in when things clear up" is a common refrain heard today (of course it was especially loud in 2009 right around the time the DJIA was bottoming at 6000). Why are people so worried today about a replay of the 2009 stock market decline? For a clue, think about earthquakes. The point of maximum fear of another earthquake is right after an earthquake has just happened. People fear the earthquake they just survived was simply a warmup for the "big one." With the stock market, leftover fear from 2009 leads skittish investors today to react to every bit of "news" as if it was a precursor to "the other shoe dropping." Reacting to distractions leads to buying and selling, which leads to stock market volatility, which ultimately leads to panic (of either a loss or missing out). Panic is an emotion, and emotion is the curse of investors. Nothing can automatically protect undisciplined investors from making decisions based on emotion. It is too powerful a human trait. Therefore, the solution is to become a disciplined investor. A disciplined investor has identified a set of goals she is working towards and a defined investment process to get to those goals. Passive investing doesn't teach discipline or help you harness other investor's emotional mistakes. Passive investing is like reading a book on how to ride a bicycle. If you really want to learn you need to get on the bike.

"You can always find a distraction if you are looking for one."

– Tom Kite, professional golfer

In summary, the world is more connected than ever before and the opportunity for getting distracted when investing is greater than ever. While most investors avoid trying to digest the minutia of soap sales, some do seem distracted with every bit of news about iPhone sales or Greece or the US NAPM-NY New York City Survey of Business Conditions. Investors get distracted by what they missed or what other investors are doing. They get distracted by investments that falsely promise the ability to put their portfolios on autopilot. They even get distracted by the idea that the government can protect them from bad investments. Most of all, investors get distracted by the volatility of the stock market. So what is the solution to not being distracted besides closing your eyes? The solution is the opposite of distraction — to focus, and to remain patient, disciplined and alert. Focus on your goals. People often hear professional athletes talk about "focusing on the target" or "being in the zone." Ben Hogan, one of the world's greatest golfers, was an example of a focused person. Once during a tournament, Hogan was so focused on his own game he didn't realize his opponent had made a hole-in-one. Remain patient, disciplined and alert. Patience comes from trusting your investment process and having the discipline to use it to take advantage of opportunities. Though the S&P 500 index, ended virtually unchanged the last decade, the volatility they experienced along the way created many opportunities. Staying patient, disciplined and alert allows an investor to sort all the data that bombards us, discarding the distractions and organizing what's useful into information. Through experience, information is translated into knowledge and through judgment, knowledge can be converted to wisdom. With wisdom, useful information can be separated from the distractions.

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Hear the Other Side

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