Defining Your Investment Philosophy

By Ben Carlson, CFA

Article Highlights

- An investment philosophy is the set of principles guiding actions when making portfolio decisions.
- Defining an investment philosophy helps an investor define what to avoid. This knowledge helps to identify what does work.
- Answering 10 simple questions will help determine what your personal investing philosophy should be.

There was a story that was told before Super Bowl XLIX, which pitted the New England Patriots against the Seattle Seahawks, about Seattle's coach Pete Carroll and his off-season speaking gigs.

Carroll is a high-energy, high-enthusiasm coach, so he gives motivational speeches to corporate leaders, other coaches, investors and even members of the military. In his talks he begins with a simple question for the audience:

"Raise your hand if you have a philosophy for your team or organization."

Of course, everyone in the room always raises their hand. What kind of leader would you be if you didn't have an overarching philosophy? Carroll then hits everyone who has their hand up with a follow-up question, by asking, "Can you describe your philosophy in 25 words or less?"

At this point, basically everyone's hand would go down.

Carroll has been known to ask this question when he interviews prospective assistant coaches for his staff. It's not necessarily that the philosophy has to be perfect, but it's the process of actually thinking it through and developing it in the first place that makes a difference. Those who can effectively communicate their philosophy have a leg up on the competition.

Every investor should also be able to explain their investment philosophy. Maybe it doesn't have to be in 25 words or less, but if you're not able to explain your philosophy in a 60-second elevator pitch, chances are you haven't developed a truly viable process in the first place.

An investment philosophy is simply a set of principles that will guide your actions when making portfolio decisions at both the macro and micro levels. Philosophy should be the starting point for every other portfolio-related decision you make as an investor. With an abundance of research, data and opinions at our fingertips in today's fast-paced world, it's easy to fall into the trap of always trying to locate the best tactics, strategies or securities to buy right now. At best, this is a patchwork system that is sure to fail. Without an overarching philosophy to bring it all together, you'll just be chasing one investment fad to the next, losing money along the way. It may seem like a minor distinction, but an investment philosophy must be determined before a portfolio strategy can be implemented.

Don't Aim for Perfection

The first point to understand is that there is no such thing as a perfect portfolio, a foolproof system, a best-in-class asset allocation, just the right amount of risk to take, or a perfect time to buy and sell in the markets. Letting go of all hope of ever finding precision in the financial markets is one of the first steps toward a truly sustainable philosophy. Investment strategies are only perfect in a sales pitch. There are no stable relationships or rules that work at all times. There isn't a single variable that can tell you when the coast is clear or when it's time to start worrying. Your unique situation and personality type should dictate your philosophy. No style will work for everyone. One of the reasons personality is such an important aspect is because there will inevitably be periods when it seems like your philosophy doesn't work anymore. It will be called into question by other market participants. There are many different ways to make money in the markets, but not all of them are suitable for certain personality types.

One of the benefits of defining a legitimate investment philosophy is the ability to understand what to avoid—what doesn't work in general or just what doesn't work for you. Knowing what to avoid, or negative knowledge, is one of the best ways to figure out what works for you as an investor. The hope is that once you figure out what all the bad stuff is, all that's left is the good stuff you should be doing. As the great Charlie Munger [of Berkshire Hathaway] once said, "Tell me where I'm going to die, so I don't go there." Making fewer choices is helpful not only to your decision-making process, but also your sanity, as it relieves unnecessary stress and anxiety.

Limits to Our Ability to Exert Self-Control

Self-control is like a muscle. The more you use it, the more decision fatigue sets in. The human brain can only perform at peak levels for so long. Think about all of the things people have to deal with on a daily basis: work, children, answering emails, cleaning the house and taking care of all of life's minor yet all too important details. Each one of these tasks uses up just a tiny bit of willpower, but add them all up and that self-control muscle gets drained.

In one study, research subjects were brought into a room one at a time and asked to memorize two-digit numbers—not exactly brain surgery. But some in the group were asked to memorize seven-digit numbers instead—still not brain surgery, but not a walk in the park either. All of the participants were then told to walk into a room that contained some food choices. The two options were a chocolate cake and fruit salad. The research subjects had to choose between the two, one a healthy option and the other a not-so-healthy option. What they found was that the subjects forced to memorize seven-digit numbers had a much harder time refraining from the cake, while the two-digit people had no problem at all. It was much harder for the people who were straining to remember their number to have enough willpower to be able to withstand the chocolate goodness. Their willpower was already used up on another task, so they gave in to the chocolate temptation.

Another study, conducted at Florida State University, also had two groups of people. One group of subjects was allowed to eat freshly baked cookies while another group was told they had to resist eating the cookies and eat radishes instead. Both groups were then given geometry puzzles that were impossible to solve. The group that was able to eat the cookies right away spent an average of 20 minutes trying to figure them out. The group that was forced to resist the cookies gave up after an average of only eight minutes because decision fatigue set in.

Finally, another study showed that when chocolates were visible and convenient, people would eat nearly three times more than when they had to walk a short distance to get just one. The whole point of defining your investment philosophy is to force yourself to find a way to create that short distance between yourself and your investment decisions. The problem with decision fatigue is that, unlike physical fatigue, you don't consciously notice when it's happening. As the number of decisions you make throughout the day increases, things eventually start to snowball until it becomes very hard for your brain to function at top speed.

More Choices Don't Lead to Better Decisions

The unfortunate byproduct of this is that it leads to mental shortcuts. These shortcuts can lead to two irrational behaviors:

1. Making impulsive decisions.
2. Avoiding the difficult decisions you need to make altogether.

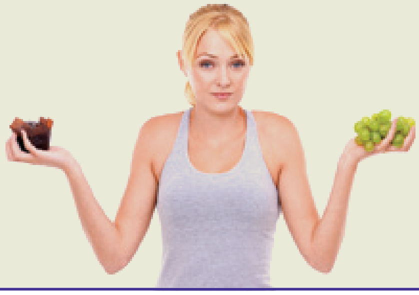
Impulsive decisions are based on intuitive feelings that require little thought or deliberation. In this situation there is little attention paid to the potential consequences of your actions. It feels better in the short run, but in

10 Questions That Will Help Define Your Investing Philosophy

The following questions can help you sort through the noise and create a personalized investing philosophy:

1. What are your core investment beliefs?
2. Do you understand your philosophy and why you believe in it?
3. Do you know the potential risks?
4. Does it suit your personality and individual circumstances?
5. Will your philosophy help you follow whatever strategy you implement?
6. What constraints are necessary for turning your philosophy into a portfolio?
7. What will you own and why will you own it?
8. What will cause you to buy or sell?
9. What will cause you to make changes to your portfolio over time?
10. What types of investments or strategies will you avoid?

Mental Exertion Hurts Our Ability to Make Good Decisions



A 1999 study by Baba Shiv and Alexander Fedorikhin asked participants to memorize either a two-digit or a seven-digit number. Afterward, they were given a choice between chocolate cake and fruit salad. Those who were asked to memorize the seven-digit number were more likely to choose the chocolate cake.

The experiment is pertinent to investors because it shows that as more decisions are made throughout the day, the harder it becomes to function at top speed. This leads to either impulsive decisions being made or, if the decision is difficult, for no decision to be made.

the long run the problems just end up compounding, making the situation even worse. Good intentions alone won't be enough to deal with this type of laziness. You have to systematically root out your own bad behavior.

People like to think that an increase in their number of choices allows them to make better decisions. Intuitively, this makes sense, but our brains function counterintuitively, so having more choices often causes people to freeze up and do nothing.

Researchers looked at a number of different 401(k) retirement plans and separated them out by the number of fund choices that were made available to workers in the plan. The plans that contained an abundance of fund options caused by far the most uncertainty in plan participants. In fact, the more funds a retirement plan offered, the lower the probability that a person would take part in the 401(k) plan. Not only is it difficult to make investing decisions with numerous choices, it can be a huge barrier to start saving for retirement in the first place. It's an overwhelming feeling.

The problem that most people have in the financial markets is they don't know what to focus on. It's so easy to focus on a little bit of everything with the constant barrage of new fund products, economic data points, talking head predictions and market surprises. A philosophy should simplify all of these factors to keep your focus on only those things that are within your control as an investor. A disorganized investment philosophy will eventually lead to poor results. That's fairly obvious, but even a good investment philosophy will be useless if you don't have discipline and patience to follow it over time. Understanding your limitations, including the amount of willpower, time, and energy you have to put into any investment strategy, should be a huge determining factor in the philosophy you choose to implement.

It's not always easy to define yourself as an investor. There are so many labels out there that it can be hard to keep up: value investor, short-term trader, index investor, active investor, diversified asset allocator, buy and hold, trend follower, macro, tactical, quant, technician, and the list could go on. There's not one right or wrong answer for every single individual. What matters most is what works for you. There's never going to be a one-size-fits-all investment philosophy for every person. We all have different strengths and weaknesses. You have to find a belief system that fits your own personality. You can't force a square peg through a round hole just because you want to make something work for you. This will only compound your issues.

Establish a Philosophy and Stick to It

Regardless of the strategy you implement, the true tests of your beliefs will always come at those times when it's not working. These are the times when your investment philosophy should help. Investor and author Rick Ferri summed this up nicely when he said, "Philosophy is universal; strategy is personal; and discipline is required. Philosophy acts as the glue that holds everything together. Philosophy first, strategy second and discipline third. These are the keys to successful investing."

Without an underlying philosophy, it's nearly impossible to implement an investment strategy because philosophy is what holds it all together when things aren't working out the way you envisioned. The discipline that Ferri describes is always going to be the most important aspect of this equation. A philosophy can't just be words. You have to actually follow through with it. Words can be hollow without the corresponding actions.

The philosophy should be there to guide your behavior. It should help you avoid crippling mistakes at the worst times. And it should help make some of the more difficult decisions that we're forced to make as an investor less stressful.

For you, the individual investor, a personal investment philosophy can help organize your beliefs, reduce the number of choices you are forced to make and avoid huge mistakes in the decision-making process. ➤

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