CLIENT'S CORNER

The Fatal Disconnect

When financial goals and investment strategy get decoupled, all hell breaks loose.

In the Book of Genesis, God gives Adam and Eve dominion over all the earth, forbidding them only from tasting the fruit of the knowledge of good and evil. And for a moment, their innocence is perfect.

Then, being only human, they succumb, and bite the apple. This is the original transgression, and when they have committed it, everything bad about earthly life comes rushing into the world: sin, shame, toil, sickness and death. They just made one mistake, but it was the one and only thing they were forbidden to do.

I think that, in a strange way, good investing is a little like that earthly paradise. Because, when it's done right, long-term investing is always seamlessly aligned with the lifetime goals of the investor and his family. There is a perfect integrity—an innocence, if you will—about goal-driven investing. It is an appropriate means to a healthy end: financial peace in the current generation, and important legacies to the generations which follow. And so long as the portfolio remains the servant of the plan, harmony reigns.

But then, being only human, we start listening to the blandishments of the serpent of markets, who says: you can beat this thing. You're smart. You don't have to rely for your fortune on the cardinal virtues of personal initiative, hard work and thrift. You don't have to be bound by the tiresome practice of faith, patience and discipline. You can find more lucrative strategies than asset allocation, diversification and rebalancing. ***You can outperform.***

When we bite into the apple of "outperformance"—when the focus of our portfolio shifts from our financial goals to the markets themselves—we commit the original sin, the mother of all mistakes. And when we give in to that temptation, every classic, return-destroying, soul-murdering behavioral proclivity to which human nature is heir comes rushing into our financial—and even our emotional—life.

This is the fatal disconnect: the end of innocence, the rupture between investment strategy and life goals. And the wonder is not that so many people bite the apple, but that anyone, in this culture, ever actually refrains from biting it.

For the serpent is everywhere. Most Americans get most of their financial input (along with most of their "news") from electronic and print journalism. And all financial journalism proceeds from the toxic assumption that you should be trying to beat the market, to select the mutual funds with the highest returns, to time your entrances into, and exits from, the markets, and to switch asset classes, market sectors and even countries in an actively opportunistic way.

This is madness, but it's a very seductive kind of madness. Because, like all systematic delusions, it has a certain very compelling internal logic to it—once you accept its totally false (and evil) premise. Namely, that the guiding principle of portfolio management is (and ought to be) "outperformance." Now, put aside for a moment the fact that consistent "outperformance" through active selection and timing isn't possible. This is inarguably true, but in the context of what we're discussing, it's actually irrelevant.

The critical issue is that "outperformance" isn't a financial goal. An income we don't outlive in a three decade retirement full of dignity and independence: that's a financial goal. Meaningful legacies to our children, delivered in tax-efficient ways, are a financial goal. The ability to be of significant financial help to our children in the education of their children: surely, a financial goal.

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We can reason backward from the timing and probable costs of these goals into a portfolio strategy, making some sort of assumptions about real long-term rates of return. Infinitely more important, we can calculate how much of our income we will have to be putting away each year—i.e. how much gratification we're going to have to defer—in this way. But we can't project relative "outperformance" forward into the achievement of these goals. And relative performance tells us next to nothing about the amounts of money we'll need to invest over time—because relative performance is an abstraction. It's everything that a real long-term plan isn't.

A market-focused, rather than goal-driven, portfolio may also be, I believe, the expression of a kind of personal irresponsibility. Somehow, if I can get the portfolio to do the heavy lifting, I won't have to defer as much gratification—I won't have to dig down and save as much money—as I know I really should. And if things don't work out? Well, it was the fault of my mutual funds (or even my advisor). That way, I get to absolve myself for not making a plan, funding it with enough savings to make it work, and sticking with it over time.

Goal-focused investing gives the investor a basis on which to consistently act, and you can only act your way to financial peace. Market-focused investing (which may be an oxymoron, because it's really just speculation on price trends) leaves you to react—to the fads or fears of the moment. And you can never react your way to financial security, nor even to superior returns.

If your portfolio is market-focused, it is in some very meaningful way cut off from your real life, and its only function must be to "outperform" the market and/or most other portfolios. This, as we've already observed, is not consistently achievable. And the frustration that comes from failing to achieve it merely sets off a downward spiral of desperate behaviors—fund-switching, trend-chasing, short-term trading, and the like—whose net effect is always to increase the rate of portfolio turnover, and to diminish returns thereby.

For let it always be remembered that turnover correlates negatively with return. And not only does active trading reduce returns, but the things traders rush to sell tend to perform better than the things they switch into. Goal-focused portfolios, on the other hand, rarely change unless and until the goals themselves change—which may not happen for decades, if ever. And, simply by dint of low turnover, such portfolios will often experience a literally effortlessly better rate of return.

Patience is perhaps the rarest quality in the American psyche, and this is even truer of investors as a class. They want—and certainly cannot be blamed for wanting—to achieve excellent returns. But your financial advisor has surely counseled you that the essential characteristic of a successful portfolio is that it is historically appropriate to your most deeply cherished life goals. And that, having built such a portfolio, your best course of action is to summon up the qualities of faith, patience and discipline which can see you through to a genuinely successful life outcome.