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Portfolio Watch

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Fee FO Only®

The 3-Legged Stool of Investing

Wouldn't it be great if we didn't always have to make tradeoffs? Why can't ice cream also be healthy for us…and no, I don't want to hear about any ice cream substitutes that are supposed to be just as good as the real thing. Or why can't broccoli taste like bacon? Or chocolate? There always has to be a tradeoff, and investing is not immune to it. I want to look at 3 desired characteristics of investments: good potential return, safety, and liquidity. It sounds like one of those 3-legged stool analogies. Unfortunately, you can only have two of the three, which makes it the Sgabellissimo* of investing.

Choose any two legs

If we were 3 years old, this would be one of those things that would result in a limp-bodied tantrum in the middle of a grocery store. However, we're older than that (some of us MUCH older), so we actually have to pick which characteristic we're not going to get when choosing an investment. First, let's be clear on what I mean by these three "legs."

Good Potential Returns: It's possible (even now) to get mid- to high-single digit returns using certain investment vehicles. If you measure from a convenient low point, stocks have been able to achieve good returns in the 7%-9% range over the long term, so that's a reasonable goal.

Safety: To make money with investments, we must take some risk, so "safety" means not having the expectation that I'm going to lose 20% or more sometime in the next 10 years. Ideally, I would like to find an 8% CD with FDIC insurance. I'm not going to, but that's what I'd like.

Liquidity: When I talk to other advisors, this often seems to be the most highly-valued characteristic. Liquidity risk is the possibility that you need access to your money and can't get to it. It's illiquid. It's just another type of risk, but it's one that perhaps hurts more if you actually get bitten by it. For that reason, it lends itself to lawsuits more than other forms of risk, so many advisors avoid it like the gym (which I'm avoiding now).

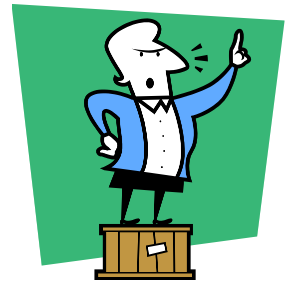
Investment Choices

The two most common choices for investments are Potential Return and Liquidity. This is the stock market that we know and love. It's had a good historical return (when measured at the right time), and it's very liquid. And very unsafe. Anytime we own a highly-liquid investment we are subject to the emotional whims of investors, and that is always dangerous. Bond funds usually have better safety and good liquidity, but you have as much chance making a good return with them right now as I have successfully guarding Steph Curry (he's a good basketball player for all you soccer fans). If we become a limited partner in an investment that has a good cash flow and a recession-resistant business model, we can get solid returns with much more safety than the stock market, but we have to give up some liquidity.

Constructing Good Furniture (or Portfolios)

Fortunately, there's this wonderful thing called "diversification," whereby (there's a word you'll never use when actually talking) we hold investments that use different combinations of these 3 legs. It takes work to make sure we don't own investments with only one leg (and there are many), but a good portfolio should take advantage of all three. Sgabellissimos* end up being dangerous.

* An Italian-designed 2-legged stool that also functions as a step-ladder.



Market Comments

We're now into June, so if the "sell in May and go away" rule of thumb holds, we shouldn't expect much from the stock market. The problem with investment rules of thumb is that as soon as they become rules of thumb they often don't work anymore. I have no idea what stocks are going to do over the summer, but it won't be dictated by a rule-of-thumb.

The factor that really dictates the market, and has for some time now, is interest rates. The Fed would like to raise them, but also doesn't want to tank the stock market, which in turn could tank the economy. As a result, a new jobs report just came out that was the ugliest we've seen in 6 years and stocks didn't mind all that much. Although it's only one month of data, that is typically enough to send stocks significantly south. Stocks did dip in the morning, but they ended up only slightly down by the end of the day. Why is that? Because bad economic news lowers the likelihood that the Fed will raise interest rates by another quarter of a percent. This is just further proof that there is no real substance to the market, but simply speculation about what central banks will do next. Again, it's been that way for quite a while. Simply not raising interest rates is not going to create another leg up for the bull market, but will probably sustain the market about where it currently is.

I received good feedback on the "Investing Like an Endowment" video, other than that it was too long. I ended up doing two versions, with one getting right to the point without trying to prove my case. There is so much "information" floating around the financial world that is pure crap that I always feel the need to present some of the logic that goes behind my thinking. I recently attended a webinar by Christopher Geczy, who is the Academic Director of the Wharton School of Finance. He presented a bunch of the academic research that backed up an Endowment Model approach to investing. It was a geeky presentation, but made a compelling case about why just stock and bond diversification has failed.