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# Table of Contents

|   |    |
|---|----|
| Stop Using Institutional Hand-me Downs .....                        | 3  |
| What is Risk?.....  | 6  |
| You do not need to lose a ton of money in order to make money. .... | 7  |
| Stay Close to Home Base.....  | 9  |
| Playing Tag .....   | 11 |
| Investment Rule 2: Stay Close to Home Base .....                    | 11 |
| Don't Lose Money .....  | 13 |
| Beware of Dragon Risk.....  | 16 |
| Predicting the Future.....  | 17 |
| Investment Rule 3: Beware of Dragon Risk .....                      | 20 |
| Mind Your Investment Seasons.....                                   | 24 |

|  |    |
|--|----|
| Investment Conditions.....                           | 24 |
| Investment Rule 4: Mind Your Investment Seasons..... | 26 |
| Market Valuations .....                              | 27 |
| Catch the Popping Corn .....                         | 31 |
| We Are Human.....                                    | 32 |
| Why Investing Is So Hard.....                        | 34 |
| Investment Rule 5: Catch the Popping Corn .....      | 35 |
| Watch For Market Swarms .....                        | 38 |
| Market Sentiment .....                               | 39 |
| Investment Rule 6: Watch For Market Swarms .....     | 40 |
| Stories Investors Tell Themselves .....              | 42 |
| Measuring Investor Sentiment .....                   | 42 |
| Track the Economic Winds.....                        | 45 |
| What Drives Corporate Profits?.....                  | 46 |
| Economic Pie .....                                   | 47 |
| Investment Rule 7: Track the Economic Winds.....     | 48 |

|  |    |
|--|----|
| Follow the Traffic Lights .....                    | 53 |
| Slow and Fast Variables .....                      | 53 |
| Investment Rule 8: Follow the Traffic Lights ..... | 56 |
| Investment Philosophy .....                        | 58 |
| Diversify Your Baskets .....                       | 60 |
| Baskets are Assets .....                           | 60 |
| Investment Rule 9: Diversify Baskets.....          | 63 |
| Don't Burn Your Ships .....                        | 65 |
| Burning Ships.....                                 | 66 |
| Investment Rule 10: Don't Burn Your Ships .....    | 67 |
| Trading .....                                      | 68 |
| Conclusion.....                                    | 68 |

# *Introduction*

How to Invest Money contains 10 Investment Rules I live by to invest my own money as well as to help Do-It-Yourself Investors invest theirs.

I developed these 10 Rules based on my nearly 20 years of advising institutions, 401k plan sponsors, financial advisors and individual investors. These rules also evolved from my day-to-day experiences in managing nearly \$2 billion in assets as Chief Portfolio Strategist for a \$33 billion investment advisory firm.

If you have any feedback or questions, please email me at [jd@j davidstein.com](mailto:jd@j davidstein.com).

- J. David Stein

# *Investment Rule 1*

*“Individual investors are not pension plans so they should stop investing like them.”*

## Stop Using Institutional Hand-me Downs

When I was growing up, I wore a lot of hand-me down clothes from my cousin. Some I liked, such as a killer pair of red bell-bottom pants, but others I despised so I kept them hidden at the bottom of my drawer.

Individual investors face the the same situation. Most use institutional hand-me-downs. These hand-me-downs are not clothes but are the tools and language that institutional investors, such as pension plans and college endowments, use to manage their portfolios. They include complicated sounding tools such as strategic asset allocation, monte-carlo simulation and market benchmarks.

While some of the tools and language are helpful, others should be stuffed in a drawer .....because they can lead individuals to make poor investment choices.

**Remember: Individual investors are not pension plans so they should stop investing like them.**

Institutional investment tools predominate because not only do institutions control the bulk of the world's investment assets, but those large pools of money

invite a ton of scrutiny and oversight. Increased visibility and focus lead to a proliferation of institutional portfolio management tools developed by academics, consultants and other investment professionals.

Unfortunately, financial advisors, 401k sponsors and the financial press often take those same tools and apply them to individual investor portfolios.

Using the same tools and language wouldn't be an issue if institutions and individuals were similar.

They are not.

There is one fundamental difference:

**People die. Most institutions do not.**

The investment time horizon for institutions is significantly longer than that of individuals. In fact, most institutions invest for perpetuity. Consequently, institutions with their longer investment periods can afford to make mistakes because there is ample time to recover from them.

That brings up another major difference between institutions and individuals.

**Institutions get second chances. People often don't.**

If institutions, such as a pension plans or college endowments, suffer devastating portfolio losses, they can go to their corporate sponsors and get more funds or raise more money from their donor base.

Most individuals don't have that luxury, particularly if they are approaching retirement. Many near-retirees learned that sad truth after suffering large portfolio losses in 2008.

My cousin's hand-me down clothes worked for me because they actually fit. That's not the case with individuals trying to manage their portfolios using institutional investment tools.



Those tools don't fit individuals because people invest for shorter time periods and they get fewer second chances.

Wearing hand-me down shoes that are too big is risky because you can trip and fall. Likewise, individuals who manage portfolios using ill-fitting institutional tools often take on too much risk.

## What is Risk?

Even such a common term as risk has a different meaning for an individual than it does for a pension plan.

Risk for an individual is the probability of losing money or of running out of money completely. If you have a shorter time frame to recover from losses and no one will come to the rescue to make you whole, then losing money is very risky.

Most institutions don't define risk as losing money but as volatility. Volatility measures the range of expected returns for a given portfolio or asset class, such as stocks or bonds. In other words, how high are the highs compared to how low are the lows. Asset classes with a wider range of potential returns (i.e. bigger swings up and down) are considered more risky.

Defining risk as volatility instead of losing money might seem like a small difference, but it is not. That definitional difference can lead to a cascade of inappropriate portfolio decisions that ultimately could jeopardize a person's ability to retire.

How could that be?

Because defining risk as volatility assumes that periodic episodes of large portfolio losses are necessary in order to meet long-term investment goals. They are not.

## **You do not need to lose a ton of money in order to make money.**

Yet, institutions believe large losses are a natural part of investing. So they minimize risk not by reducing the chance of losing money, but by choosing a portfolio mix that minimizes portfolio swings for a given level of return.

Institutions are willing suffer through large losses while adhering to their target portfolio mix because they believe the bad years will be more than offset by the good years. And if they aren't, institutions can always raise more money.

**Bottom line: Individuals can't afford to lose large amounts of money when they invest so they shouldn't use hand-me down institutional tools that encourage it.**

In the next several lessons, we will begin to explore the correct tools you should be using to invest your money.

### **Here's a checklist summary of today's lesson:**

- Individuals are different from institutions so they shouldn't invest like them.
- The main differences: People die and don't often get second chances. Institutions can live forever and cover their mistakes by raising more money.
- Risk for an individual is losing money. Risk for an institution is volatility.
- Institutions believe large portfolio losses are a natural part of investing.

- Individuals should structure portfolios to minimize large losses because they can be so devastating.

# Investment Rule 2

*“Individuals shouldn’t care about relative performance. They should care about whether they are making money or not.”*

## Stay Close to Home Base

In Investment Rule 1, we reviewed why individual investors shouldn’t use institutional hand-me downs to manage their investment portfolios. It all comes down to risk. Risk for an individual is losing money, which can be devastating if the losses are large. Losing money is a sure-fire way to never reach your retirement savings goal.

Institutions, such as pension plans and college endowments, define risk as volatility or the range of expected returns. By defining risk this way, institutions assume that large portfolio losses are unavoidable.

Institutions are willing to suffer through losses while adhering to their target portfolio mix, because they believe the bad years will be more than offset by the good years. And if they are not, institutions can always raise more money.

Individuals who copy how institutions invest take on too much risk. Sadly, copying institutions is why in 2008 many retirees and near-retirees lost 30% or more on their investments, forcing many to postpone retirement or cut back on expenses.

**Remember: Definitions Drive Behaviour**

Define risk as volatility and that leads to certain investment decisions. Define risk as losing money and the investment decisions will differ.

The same is true even for games.



## Playing Tag

For example, in the childhood game of “Tag” there is often a “home base” where players are safe from being tagged.

In a typical game, if you are tagged somewhere away from home base, you become “It” and start chasing others to try and tag them. The risk in a normal game of Tag is suffering the minor disgrace of being caught and becoming “It.”

Suppose, though, the consequence of being tagged is you must pay out 20% of your net worth to the score keeper. Now the primary risk is losing money.

How would that alter your game strategy?

I suspect when there is the risk of losing money you would be less willing to venture as far from the safety of home base. In fact, that is the second investment rule for a thriving portfolio.

## Investment Rule 2: Stay Close to Home Base

So where is home base in investing?

It depends on your definition of risk. Again, definitions drive behavior. For an individual defining risk as losing large sums of money, home base is the target portfolio mix that minimizes the devastating impact of losses. That is their risk neutral position.

A target portfolio mix is the defined allocation between the various investment types such as stocks, bonds, and cash.

This risk neutral position or home base can differ between individuals.

A 30 year-old investor with \$30,000 in his 401k portfolio will have a different risk neutral position than a 55 year-old with close to \$750,000 in her retirement investment portfolio.

Who will lose more money (in dollar terms) if their portfolios fall 30%? Who has a shorter time to recover from those losses? The 55 year-old of course.

The 55 year-old will have a home base position with a much higher target percentage in cash than a 30 year-old.

Home base exerts a powerful psychological pull on investors just as a magnet attracts iron. Shifting a portfolio too far away from risk neutral can cause extreme discomfort.

For example, most institutions measure their performance against a policy benchmark comprised of various market indices such as the S&P 500 Index and the Barclays Capital Aggregate Bond Index. This policy benchmark represents their risk neutral position.

Each quarter, the institution's portfolio return is compared to the return of that home base benchmark. It is a scorecard. And when that portfolio trails the home base benchmark, especially if it is due to the current asset mix differing from the long-term target allocation, it causes a great deal of angst.

I have seen institutional investors gladly accept losses on their portfolios as long as they outperformed or were in line with the home base policy benchmark. Likewise, I have also witnessed institutional investors that were livid because they trailed their home base benchmark, even though their portfolio had gained 20% or more.

Individual investors shouldn't care about relative performance, yet how much time is wasted seeking to identify which mutual fund can outperform a market benchmark.

A saying in the investment industry is you can't spend relative performance. And it is true. What matters is whether the portfolio is making money or not.

### **Don't Lose Money**

Years ago a financial planner client of mine hammered home this point. Whenever I would tell him how well the portfolios I was managing for his retiree clients were doing compared to a market benchmark, he would raise his voice and say,

"Don't talk to me about market benchmarks. My clients don't care about them. All they care about is whether their investments went up in value or not."

It was an eye opener.

### **How You Are Like A Hedge Fund**

While individuals shouldn't copy how institutions invest, there is one class of institutional investor they can learn from: Hedge funds.

Hedge funds are sophisticated investment partnerships used by institutions and high net worth individuals. Hedge funds managers, like individuals, have a home base or risk neutral position designed to avoid losing large sums of money.

When hedge funds lose money, the consequences can be just as devastating as portfolio losses are to individual investors.

Hedge funds earn incentive fees for generating positive returns, not for outperforming a benchmark. Typically they receive 20% of the earned profits.

When hedge funds lose money, not only do they not receive their incentive fee that year, but they don't receive future incentive fees until the portfolio balance has reached its previous peak. That peak is called the high-water mark.

Just like a flood will leave a line on a building showing how high the water reached, a hedge fund manager has to reach his or her previous portfolio high to receive a cut of the profits.

While incentive fees provide hedge funds with a compelling motivation not to lose money, there is an even a more powerful deterrent. Hedge funds that lose too much money eventually go out of business because their clients flee. Hundreds of hedge funds close down annually for this very reason.

Hedge funds just like individuals can suffer catastrophic consequences if portfolios incur large losses. Consequently, individuals can learn more from how hedge funds invest than they can from institutional investors such as pension plans.

In Rule 3, we will begin to explore whether there are times investors should shift their investment portfolio allocation away from their home base or risk-neutral target mix.

## **Here's a checklist summary of today's lesson:**

- An investor's definition of risk will drive their investment behavior and portfolio mix.
- Home base is an investor's risk neutral position.
- The risk neutral home base for both individuals and hedge funds should be the target portfolio mix that minimizes the devastating impact of large losses.
- Home base exerts a powerful psychological pull on investors. Shifting a portfolio too far away from risk neutral causes extreme discomfort.

# Investment Rule 3

*“The more specific  
the prediction, the  
more likely it is to be  
wrong.”*

## Beware of Dragon Risk

In Investment Rule 2, we explored how an individual investor's risk neutral position, which we called home base, should be the target portfolio mix that minimizes the devastating impact of large losses.

We saw how the home base allocation can differ between individuals depending on their age and the size of their portfolio.

Younger investors with smaller portfolios will suffer smaller absolute losses in dollar terms and have more time to recover from them than an investor with a large portfolio that is approaching retirement age.

An individual investor's risk neutral position is much more like that of hedge funds than it is institutional investors, such as pension plans or college endowments.

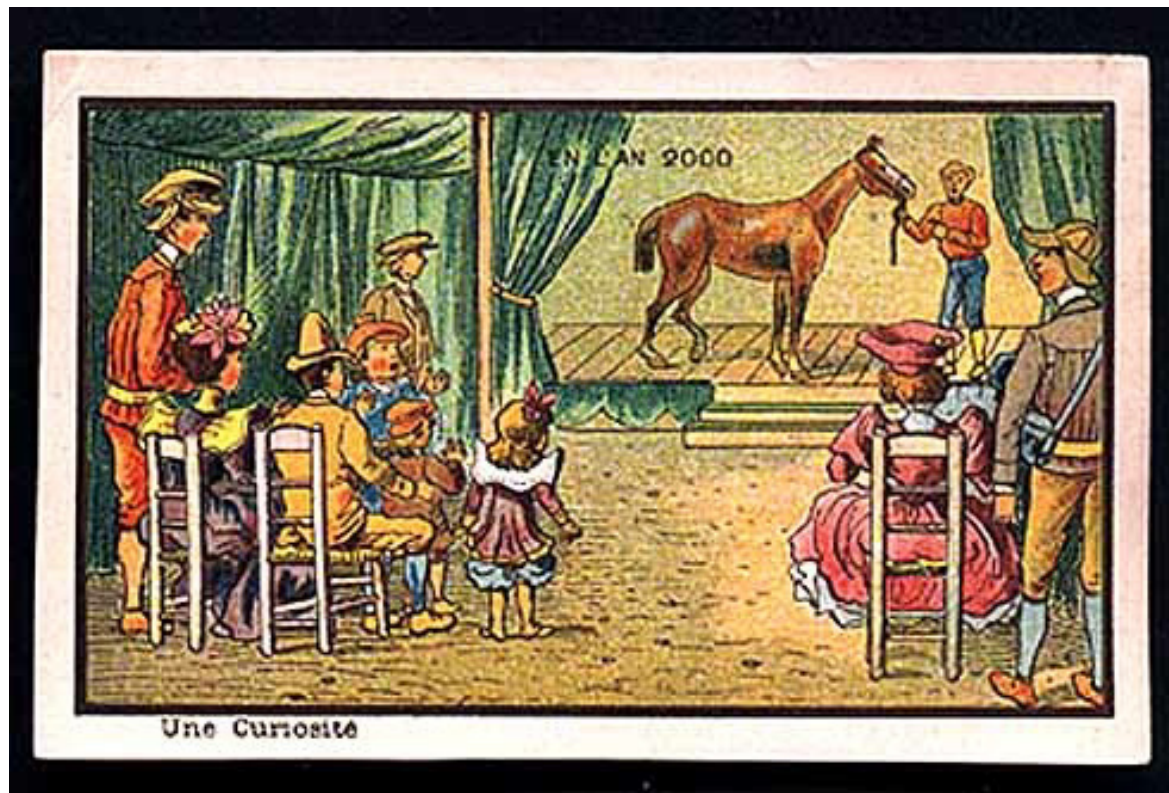
The investment rule was Stay Close to Home Base.

Today we want to explore whether investors should ever venture from home base, and if so, when and how.

Before doing that, we need to discuss your future. Okay, not your specific future, but the future in general.

## Predicting the Future

Imagine a world where strawberries are as big as apples and peas are as large as beets. In this world, mosquitoes, flies and roaches have been exterminated, while horses are nearly extinct. It is a land where packages are delivered through a network of pneumatic tubes and the letters “C”, “X” and “Q” have been eliminated from the everyday English alphabet in order to simplify it.



These were some of the predictions made by John Elfreth Watkins, Jr. in a Ladies Home Journal article published in the year 1900 entitled, “What May Happen in the Next Hundred Years.”

Most of his predictions were wrong, although a few were correct. Watkins correctly predicted wireless telephones and the television.

Now imagine trying to pick investments based on those predictions. Even if you believed a television was possible, which company would you invest in?

Investing would be easy if we knew what was going to happen in the future. But predicting the future is incredibly difficult.

Our predictions are fuzzy like seeing a giraffe in the distance. We leave out important details and put too much emphasis on the details we imagine.

Those imagined details are heavily influenced by our present attitudes, feelings and knowledge. So most predictions end up being an extrapolation of current trends.

We view the future through the lens of the present.

### **The Unpredictable**

What gets left out of all predictions is the unpredictable – the unexpected events, the surprises. It is these surprises that have the greatest impact on the future. They are the game changers that can swamp the incremental improvements and current trends.

Since most forecasts are simply extrapolations of current trends, it's understandable most predictions are wrong because they are torpedoed by disruptive events and surprise technological breakthroughs.

If most predictions are wrong, then we want to invest in a way that avoids trying to predict the future.

That doesn't mean, however, we can't control our portfolio outcome.

While predicting is difficult, you still need to actively manage your investment portfolio.

Some people assume that because predicting is difficult, investors should allocate their investments to a handful of mutual funds and rarely make changes, other than to periodically rebalance back to their target.

In other words, these investors climb on the market roller coaster and hold on for dear life as they watch their investment portfolio plunge when markets fall in hopes that portfolio gains will more than offset those losses.

That's how institutions invest. But you are not a pension plan. You don't have the option of having your employer add extra funds to your portfolio to make up for large dollar losses.

Instead, you have to invest in a way that avoids large dollar losses while also earning a sufficient return to grow your portfolio so you can eventually retire.

So how do we go about doing it? One way is by following our next investment rule.

## Investment Rule 3: Beware of Dragon Risk

Dragon risk is a term adopted by two investors I highly respect Cliff Asness and Martin Leibowitz. It refers to how medieval map makers used to draw dragons and other mythological creatures on the unexplored territories of their maps, signifying unknown dangers that could reside there. In investing, dragon risk represents all the unknowns that can lead to large portfolio losses.

Dragon risk is why we stay close to home base.

The further we shift the portfolio from cash and into more volatile investments such as stocks, the more exposed the portfolio is to unexpected events and negative surprises. In other words: dragon risk.

Hedge funds reduce dragon risk by hedging. They find the most cost effective ways at any given point in time to protect their portfolios against losses. They usually do so by purchasing derivative securities. If you don't know what derivatives are don't worry about it, because you won't need to use them to build a thriving investment portfolio.

While many hedge funds won't admit this, if you probe and ask what specific event they are hedging against, often they will say they don't know. They are hedging against unpredictable, unknowable bad events.



Black Swans is what Nassim Nicholas Taleb called them in his book by the same name. Dragons is the term we will use.

While buying portfolio hedges is one way to protect against dragon risk, that is not an option for most individual investors.

Individual investors can protect against portfolio losses by staying close to home base and venturing out into the investing wilderness only when conditions are favorable.

We will start learning about what comprises favorable conditions in our next lesson.

Notice, though, I said we would identify favorable conditions for taking on more portfolio risk not predict specific events or outcomes.

**Remember: The more specific the prediction, the more likely it is to be wrong.**

As predictions become more detailed, not only do they become more skewed by our present opinions and biases but there are also a lot more things that could go wrong. More specifics exposed to dragon risk.

A critical component to building a thriving portfolio is to not have your investment success dependent on specific predictions. This advice seems to run contrary to what you hear from some of the great investors, such as Warren Buffet and Peter Lynch. They say, “Invest in what you know.”

The reality is most investors, including most professional investors, don’t know enough to run an entire portfolio investing in what they know. Perhaps they have an informational edge or superior knowledge on a few of their investments that allows for some very specific predictions, but for the entire portfolio? I don’t think so. Invariably, they get tripped up by something unforeseen and unexpected – a dragon.

In Rule 4, we will begin exploring how to identify favorable investment conditions.

## **Here's a checklist summary of today's lesson:**

- Investing involves predicting the future.
- What gets left out of all predictions is the unpredictable – the unexpected events, the surprises.
- The more specific the prediction, the more likely it is to be wrong.
- The further a portfolio moves out of cash and into more volatile investments such as stocks, the more exposed the portfolio is to unexpected events and negative surprises.
- Investment success comes from identifying favorable conditions for taking on more risk, not predicting specific events or outcomes.

# *Investment Rule 4*

*“Just as the changing tilt of the earth allows us to identify the winter weather season, there are ways to identify favorable investment seasons.”*

## Mind Your Investment Seasons

In Investment Rule 3, we explored dragon risk – those unexpected events and negative surprises that are impossible to predict. The primary way to protect against unpredictable events that can inflict large portfolio losses is to stay close to home base, which for individuals is the target asset mix that won't cause retirement ruin if the stock market suffers a steep decline.

There are times, though, when investment conditions are favorable that investors can significantly increase their expected portfolio return while only modestly increasing the probability of portfolio losses.

What do I mean by investment conditions?

## Investment Conditions

Favorable investment conditions can be thought of as favorable weather. Just as you don't launch a sail boat when heavy storms are likely, there are favorable investing conditions when the sun is shining and there is a tailwind that raises the likelihood of positive portfolio returns.



Identifying favorable conditions is much easier than predicting specific events. It is the difference between predicting that it will be cold this winter versus whether it will snow on Christmas Day.

The more specific the prediction, the more likely it is to be wrong.

The reason it is easier to predict it will be cold in the winter is because winter is a season not a one day event. Winter is a time when due to the angled axis of the earth either the Northern or Southern Hemisphere is tilted further away from the sun, receiving less of its energy. Hence, it is darker and colder in the winter. While some winter days are colder than others, it is a safe bet that the average winter temperature will be colder than in the summer.

Our clothes and activities are different in the winter than in the summer. Likewise, investors should adjust their portfolios according to the investment season. That is our next rule:

## **Investment Rule 4: Mind Your Investment Seasons**

Just as the changing tilt of the earth allows us to identify the winter weather season, there are ways to identify both the investment winter, when markets are more likely to deliver negative portfolio returns, and the investment summer when market conditions are more favorable. Note, though, that does not mean markets can't go down during the investment summer.

My office is in Teton Valley, Idaho overlooking the Teton mountain range. A while back, the local newspaper asked a few readers when was the earliest in the Fall they had seen snow. One respondent said June.

Just as it can snow near my office during the summer, markets can go down even when conditions are favorable.

That is why even though some investors may want to venture further from home base during investment summers, they shouldn't take on excessive risk by dramatically increasing stock exposure.

There are always dragons lurking even when conditions are more favorable.



## Market Valuations

So how do we identify the current investment season? Market valuations.

Market valuations measure whether an asset category, such as stocks or bonds, is pricey or cheap.

**Remember: Valuation is the thermometer for determining the investment season.**

Now there are hundreds of different valuation metrics, but today I want to introduce one I have found to be very effective in determining the investment season.

Before introducing it, let me point out that so far in this ebook I have purposely not used any numbers, statistics or other complicated techniques. The focus has been on introducing investment rules to lay the foundation for a thriving investment portfolio. Not zero in on specific statistics. I regularly address specific valuation statistics and the investment season on my blog and newsletter.

## P/E Ratios

One valuation metric that is effective in determining the investment season is the price-to-earnings ratio using normalized earnings (P/E ratio).

Now that is a mouthful. Let's break it down.

The P/E ratio divides the current price of an index, such as the S&P 500 Index, by the aggregate average earnings for the previous 10 years for the stocks that comprise that index. So it is the price divided by earnings – hence P/E.

By using the 10-year average or smoothed earnings, the P/E ratio is more reflective of longer term trends – in other words the investment season – as opposed to being unduly influenced by that years earnings.

When the normalized P/E ratio for the S&P 500 Index has been below 14, an investment summer, the average gain the following year for the stock market has been 17.1%. Conversely, when the normalized P/E ratio has been above 20, an investment winter, the average return for the stock market the following year was 2.3%, with many of the years being negative.<sup>1</sup>

More importantly, normalized P/E ratios have been effective at predicting longer term market performance. P/E ratios above 20 have generally corresponded to below average returns for the stock market over the subsequent decade while P/E ratios below 11 have corresponded to above average returns for the stock market.

For example, in the year 2000 the normalized P/E ratio for the S&P 500 Index was at an unprecedented high of over 40. With such a high market valuation, is it any wonder the S&P 500 Index suffered a negative annualized return over the next decade, upending the investment plans of many individuals who were anticipating double digit returns to fund their retirement.

While investing is not as simple as as using one valuation metric, such as the normalized P/E ratio, investors who are mindful of the investment season will be in a much better position than those who were blindly buying Internet stocks at the top of the market in early 2000.

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<sup>1</sup> Ned Davis Research

In fact, it was that indiscriminate buying that led the stock market to become overvalued in the first place.

In Rule 5, we will explore why markets do better when they are less expensive (an investment summer) and how to take advantage of it.

**Here's a checklist summary of today's lesson:**

- The most prudent time to shift funds away from home base into potentially more profitable investments is when conditions are favorable.
- Favorable investment conditions provide a tailwind for positive investment returns.
- It is easier to predict a favorable investment season than it is to predict a specific favorable event.
- Market valuation is a thermometer for determining the investment season.
- Investors who are mindful of the investment season will be in a better position to avoid portfolio losses and generate positive returns.

# *Investment Rule 5*

*“Investors are human and humans are irrational.”*

## Catch the Popping Corn

In Investment Rule 4, we learned if we are mindful of the investment season we will be in a better position to avoid portfolio losses and generate positive returns. We reviewed that market valuation is the thermometer for determining the investment season. Market valuations measure whether an asset category, such as stocks, is expensive or cheap.

One valuation metric we explored was the normalized price earnings (P/E) ratio. The normalized P/E ratio divides the current price of an index such as the S&P 500 Index by the aggregate average earnings for the previous 10 years for the stocks that comprise that index. So it is the price divided by earnings – hence the P/E.

We found that the normalized P/E ratio was effective at predicting longer-term market performance as above average P/E ratios (an investment winter) generally led to below average returns for the stock market over the subsequent decade. The opposite was also true.

Today we want to review why lower valuations often lead to higher than average portfolio returns. The reason is simple.

## We Are Human

Investors are human and humans are irrational. That means we are not trading automatons, but we bring to the investment table all the emotions, biases and flat out inconsistencies and cognitive errors that plague the rest of our lives.



One of those inconsistencies is our tendency to extrapolate recent experience far into the future.

If a stock has appreciated and the portfolio company is doing well, we believe those trends will continue. In fact, our minds seek out information that confirms our belief while discounting items that contradict our current positioning.

Conversely, when an investment is doing poorly and losses are mounting, the distaste is palpable. After we sell, the memory of that loss stays with us for a very long time.

We often want nothing to do with an underperforming stock because we believe the company's struggles will continue indefinitely.

When you multiply those feelings and tendencies across millions of investors and thousands of investment securities is it any wonder that unloved investments get cheaper while popular holdings appreciate and become more expensive?

### **How to Become a Brilliant Investor**

How can investors take advantage of those behavioral biases?

Two common investment approaches that seek to take advantage of investors' irrationality are value investing and momentum investing.

To become brilliant value investors all we need to do is identify which specific securities are cheap. Then we need to determine the tipping point when more and more investors discover they have overreacted and are too pessimistic about the company's prospects so they reverse course and start buying the security. That's when we buy the cheapest securities that are beginning to turn and subsequently reap huge profits.

The second approach is momentum investing. To become brilliant momentum investors, we need to identify the most popular securities with the most believers and ride the price up, making sure to sell right before investors realize they have become too bullish or the company makes a disappointing announcement that sends the stock tumbling.

## Why Investing Is So Hard

Unfortunately, there are very few investors, even professionals, who are successful over the long-term at either strategy.

I spent over 16 years personally meeting with hundreds of investment firms and co-led a 21 member research group who in turn met with thousands of firms seeking to find the chosen few professionals with investment skill. They are very difficult to identify, particularly because unskilled investors get lucky and skilled investors go through periods of underperformance.

Success at investment security selection depends on accurately predicting specific outcomes. As we learned in previous lessons, the more specific the prediction the more likely it is to be wrong. More often than not the prediction will be upended by unexpected events. Negative surprises. Dragon risk.

What we need is a way to take advantage of the irrationality of investors that causes certain securities to become undervalued without resorting to making specific predictions.

There is a way. It's called:

## Investment Rule 5: Catch the Popping Corn

Consider how a popcorn popper works. Hundreds of popcorn kernels spin around an air popper's chamber. Tucked inside each kernel's hard shell is a water droplet in a pocket of starch. As the temperature in the popper rises, the moisture begins turning to steam.



Pressure builds inside the kernels until one by one the casings give way in a steam explosion so powerful the kernel turns inside out as it arcs through the air.

Apply enough heat and popcorn will pop. That outcome is certain. Knowing beforehand which popped kernel you will catch in the air is impossible.

So what does catching popcorn have to do with investing your money?

When we invest in an asset category, such as emerging markets stocks, that is selling for a valuation well below its historical average it is like discovering a bunch of unpopped corn kernels sitting on a heat source.

By investing in a diversified basket of undervalued securities we don't have to guess which security will appreciate just like we don't have to guess which kernel will pop first. We just know that there is a greater likelihood for positive surprises and corresponding market appreciation in a basket of securities that is cheap.

On the flip side, there is a greater likelihood for negative surprises when purchasing a basket of richly valued securities that is priced for perfection.

Believe me, one of things that has helped me to be a less stressed investor is knowing I own baskets of undervalued securities chock full of embedded positive surprises, and I don't have to predict what those surprises are.

In an upcoming lesson, we will explore to access those baskets for your investment portfolio.

In Investment Rule 6, we will learn how investors' emotions help fan the flames that make investment kernels more likely to pop. Investors get fearful and greedy, and being mindful of their current sentiment can help guide our thriving portfolio.

## **Here's a checklist summary of today's lesson:**

- Investors are human and humans are irrational.
- Investors' tendency to extrapolate both good and bad trends far into the future leads to undervalued and overvalued securities.
- Trying to pick which undervalued security is going to appreciate is very difficult because it means predicting specific outcomes.
- It is better to pick a diversified basket of undervalued securities because there is a greater likelihood of positive surprises.
- To manage a thriving investment portfolio we must venture from home base during favorable investment seasons and invest in diversified baskets of undervalued securities that are embedded with positive surprises, none of which we have to predict beforehand.

# Investment Rule 6

*“Just as swarming birds seem to move as one, there are times when investors seem to act in unison causing markets to plummet or soar.”*

## Watch For Market Swarms

In Investment Rule 5, we explored how we can profit from investing in undervalued securities without having to make specific predictions. We can do so investing in diversified baskets of undervalued securities. Those investment baskets are chock-full of positive surprises, none of which we have to predict beforehand. Positive surprises lead to market appreciation.

An undervalued basket of securities is like kernels of unpopped corn sitting on a heat source. We know we will eventually get to eat some popcorn without needing to predict which specific kernels will pop.

In this chapter, I want to share another tool to fine tune the process for deciding if an investor should venture from home base further into the investing wilderness given the dragons, or unexpected events, that lurk there.

Remember, individual investors don't ever have to leave the safety of home base. They can still earn an adequate market return and not have to worry about large portfolio losses that could devastate their retirement plans.

Of course, those investors will need to be extra diligent savers since their overall portfolio return will likely be lower than the return for investors who occasionally shift funds from home base during favorable investment seasons.

In Lesson 4, we saw how market valuations are helpful guides in determining the investment season. Yet, just as it sometimes snows near my Teton Valley, Idaho office during the summer, markets can fall even when the season is favorable. To better determine market conditions and the appropriate portfolio response we need more tools than just a market valuation thermometer.

Ideally, there are tools to help us determine when the season is about to change or at least when a storm is brewing. We need an investment barometer.

## Market Sentiment

A weather barometer helps in short-term weather forecasting by measuring changes in atmospheric pressure. The equivalent in the investment world is investor sentiment. Sentiment measures the emotional pulse of investors. Their level of fear and greed. It measures the predominate narratives or stories that are driving investment markets.

We already know that investors are irrational in that they become both overly pessimistic and overly optimistic about the prospects of certain companies. That is what creates undervalued securities.

Most investors don't make up their minds about a company's prospects independently. They read, talk, share, and tweet. More than anything investors

seek confirmation from others that they made the right investment decision. Very few investors have the fortitude to stand alone. We are social creatures.

What happens when millions of investors are looking over their shoulders seeking confirmation that they made correct investment decisions? At times, it causes swarms.

## **Investment Rule 6: Watch For Market Swarms**

Just as swarming birds seem to move as one, there are times when investors seem to act in unison causing markets to plummet or soar.

During downward swarms, we want to be close to home base, protecting our portfolio against losses. During upward swarms, some investors may want to be further out in the investment wilderness, capturing the potential market appreciation.

Of course, every investment transaction has both a buyer and a seller so it is impossible for all investors to be swarming in the same direction. Still, markets become gripped by periods of fear and greed when it appears as if investors are indeed acting in unison.

How can that be?

Well, while it is true every transaction has both a buyer and seller, it is the supply and intensity of potential buyers and sellers that set the direction prices are moving.



An initial decline in the stock market might trigger a new wave of selling, and while there are buyers to meet that wave, the further fall in the market might trigger an even bigger wave of selling as more investors throw in the towel.

In other words, the fear that drives sellers overwhelms the greed exhibited by buyers. The result is negative market sentiment.

## Stories Investors Tell Themselves

A drop in atmospheric pressure as measured by a weather barometer suggests a storm is approaching. Yet, there is still a great deal of subjectivity regarding the intensity, duration and even location of the storm. Nevertheless, knowing there is an approaching storm even if some of the details are fuzzy is better than not knowing at all. It keeps us from being blindsided.

Likewise, there is a great deal of subjectivity in measuring investor sentiment. After all, we are trying to assess the supply and intensity of potential buyers and sellers – who are still on the sidelines. Consequently, there is not one barometer we can turn to to measure investor sentiment. Instead, we must weave together numerous indicators in order establish the predominant sentiment pattern that is driving markets.

We want to know what stories investors are telling themselves and whether those stories are changing. Changing stories lead to changing market conditions.

As investors, we can be more confident in leaving home base and invest in riskier assets when valuations are attractive and when prevailing investor sentiment has turned favorable.

## Measuring Investor Sentiment

So what type of indicators do we look at to measure investor sentiment?

Several that I review regularly include consumer confidence, the percentage of individual and professional investors that are bullish or bearish about the stock market, and mutual fund inflows and outflows.

Another one of my favorite sentiment measures is the trading volume for stocks that are rising compared to the trading volume for stocks that are falling. This is a proxy for the supply and intensity of potential buyers and sellers.

The breadth of market advances and declines can also be a useful measure of investor sentiment. In other words, are the majority of securities increasing in price or is the market being led only by the largest companies.

Some sentiment indicators are contrarian in nature. If most investors are overly optimistic, that can actually suggest the market is at risk of falling. Again, we are trying to determine if the narrative driving a particular securities market is changing so when a sentiment indicator hits an extreme and begins to reverse that is often the sign of a changing story.

The bottom line is by looking at a cross section of subjective sentiment indicators we can get a sense of whether investors are starting to swarm and position our investment portfolio accordingly.

By combining the barometers of sentiment with the thermometers of market valuations, we are better able to assess not only the investment season but whether market conditions are becoming more favorable within that season.

Favorable market conditions within an investment summer give us confidence to invest our money further from home base in order to hopefully achieve higher returns.

Granted, many individual investors don't have the time or the desire to be researching valuations and market swarms. That is one reason my clients choose to get customized investment portfolio recommendations along with ongoing plan updates based on changing market valuations and investor sentiment. You can learn more about that at <http://www.jdavidstein.com/advice.html>

In Investment Rule 7, we will explore a final tool that we can combine with sentiment and valuations to guide our thriving portfolio.

**Here's a checklist summary of today's lesson:**

- Sentiment measures the emotional pulse of investors, their level of fear and greed.
- Just as swarming birds seem to move as one, there are time when investors seem to act in unison causing markets to plummet or soar.
- By weaving together numerous sentiment indicators, we seek to assess the predominant story driving markets and whether it is changing.
- By combining the barometers of sentiment with the thermometers of market valuation, we are better able to assess not only the investment season but whether market conditions are favorable within that season.
- It is during those favorable times when we can be most confident in investing further from home base in order to hopefully achieve higher returns.

# *Investment Rule 7*

*“Our goal should be to assess current economic trends and conditions; not predict specific economic outcomes.”*

## Track the Economic Winds

In Investment Rule 6, we explored how investor sentiment is an additional tool for deciding how far we should venture from home base and into the investing wilderness given the dragons, or unexpected events, that lurk there. Investor sentiment measures the emotional pulse of investors; their level of fear and greed.

By studying sentiment, we are better able to identify the stories investors are telling themselves and whether those stories are changing. Changing stories lead to changing market conditions and potentially to market swarms.

Just as swarming birds seem to move as one, there are times when investors seem to act in unison causing markets to plummet or soar.

During downward swarms, we want to be close to home base, protecting our portfolio against losses. During upward swarms, some investors may want to be further out in the investment wilderness, capturing the market appreciation.

In this chapter, I share a final tool that we can combine with the barometers of sentiment and the thermometers of market valuation in order better create a thriving investment portfolio.

## What Drives Corporate Profits?

Think for a moment of the market valuation metric we highlighted when discussing Investment Rule 4 to determine the investment season. We looked at the normalized price/earnings (P/E ratio), which consists of the price of a specific stock index, such as the S&P 500 Index, divided by the average aggregate earnings or corporate profits of the companies that comprise that index.

If we use the earnings for the past 12 months instead of the past 10 years, the P/E ratio reflects what investors are willing to pay for \$1 of collective earnings from the companies that comprise the index.

We know the price investors are willing to pay for earnings is heavily influenced by investors' emotional state – in other words, by investor sentiment.

What influences the earnings?

At the individual company level there are a host of micro factors that influence earnings such as the strength of a company's product line up, the quality of its leadership, actions by competitors, etc.

At the index level, these micro factors cancel each other out since companies compete against each other. Ford takes market share from General Motors and vice versa. Apple releases the iPhone and takes market share from Samsung.

Consequently, what drives the total earnings of an index is the trajectory of the overall economy. If the economy is growing then total corporate profits are growing – even though some companies within an index might have declining profits while others are rising rapidly.

## Economic Pie

Investors who strive to make money by predicting specific company outcomes care about how the economic pie is being divided among the various competitors.



divided among the various competitors.

As individual investors seeking to catch the popping corn by purchasing undervalued baskets of securities, we only care whether the pie is growing or not.

If the pie is growing, then there will be more embedded positive surprises in those baskets of securities.

Shifting our focus to the entire economic pie is a completely different exercise than trying to keep track of the endless shifts among the individual company pieces.

In fact, there is additional meaning found in studying the whole economic pie that goes beyond the sum of the individual pieces.

For example, consider how the words and letters of this sentence I am typing combine to create a meaningful thought.

That thought is not simply the sum or the average of the individual letters.

The knowledge gained by reading the sentence is useful because it encompasses far more than the simple average of the words and letters.

Likewise, a study of economic indicators provides meaning beyond a simple average of a handful of data points.

The constant flow of economic data provides context to better understand whether conditions are sufficiently favorable to shift assets further from home base in order to increase our potential portfolio return. In other words, is there an economic headwind or tailwind?

That introduces are next investment rule:

### **Investment Rule 7: Track the Economic Winds**

A valuation metric, such as the normalized price earnings ratio, is just a snapshot in time. We want to know what lies behind those raw numbers and what direction they appear to be heading.



That is why we study both investor sentiment – to better understand the stories driving price – and track the economic winds – to better understand the direction of corporate profits.

**Remember: Our goal is to comprehend current economic trends and conditions, not predict specific economic data points.**

As with any prediction, the more specific it is the more likely it is to be wrong.

Fortunately, economic trends tend to persist and there is sufficient advanced warning when economic headwinds look as if they could negatively impact corporate profit growth.

Conversely, economic tailwinds can lead to increased corporate profit growth, making positive surprises more likely within our basket of undervalued securities. Economic tailwinds can also lead to positive investor sentiment.

## Economics and Politics

An interesting dynamic with economic analysis is the way investors often confuse how the economy works with their political opinions of how they think it should work.

Governments comprise a sizeable portion of the global economy while central banks also play an influential role. Where there is government, there is politics.

It is surprising how many investors, including sophisticated hedge funds, allow their political opinions to influence the way they believe the economy functions and then invest accordingly.

Consequently, there is a great deal of irrationality and emotion surrounding the release and interpretation of economic data. This creates opportunity for investors who truly understand how the economy functions.

This How to Invest Money ebook is focused on introducing the investment rules that lay the foundation for a thriving investment portfolio, rather than expounding on specific economic indicators. I regularly address the direction of the economic winds and specific indicators to my newsletter subscribers and on my blog. You can learn more at <http://www.jdavidstein.com>.

In Investment Rule 8, we will learn how to combine the analysis of market valuations, investor sentiment and the economic winds to make individual portfolio decisions.

### **Here's a checklist summary of today's lesson:**

- Market valuation metrics used to help determine the investment season are just snapshots in time.
- By studying a valuation metric's underlying components, such as price and earnings, we can better understand if market conditions and/or the investment season are changing.
- Tracking the economic winds gives us insight into the direction of corporate profits.

- We study the economic pie to comprehend current trends and conditions, not predict economic outcomes.
- Investors tendency to invest based on their political opinions of how they think the economy works creates opportunities for those who truly understand how the economy functions.

# Investment Rule 8

*“Market valuations,  
economic analysis  
and investor  
sentiment can be  
thought of as traffic  
lights, each  
individually  
flashing red, green  
or yellow.”*

## Follow the Traffic Lights

In earlier lessons, you were introduced to three tools to determine the investment season and market conditions. The tools were:

1. Market Valuations
2. Investor Sentiment
3. Economic Wind Analysis

Today I want to share how I prioritize those tools to guide me in making individual portfolio decisions.

## Slow and Fast Variables

The first step is to separate the data we analyze with our three tools into slow variables and fast variables.

Slow variables are items that don't change very often like the seasons of the year. Since slow variables are more constant, we put more emphasis on them in structuring portfolios so that we have a higher degree of confidence in our decisions and minimize the number of portfolio trades.



Market valuations are slow variables. That is why we use them to determine the investment season. Valuations change, but in a normal market environment those changes can take months, just as it takes several months to go from winter to spring.

A switch from an economic tailwind to a headwind is also a slow variable. Each week there is a flow of new economic data released, making it appear as if the economy should be a fast variable. The reality is that while economic data is constantly changing, a significant switch in economic direction usually takes months to evolve.

Despite the economy being slow variable, I spend more time reviewing and explaining it in my talks and writings than I do market valuations because not only is there more economic information to digest, the economic winds help drive corporate profits, a key component to market valuations.

Investor sentiment is our one fast variable since it is driven by investor emotion. We know how fickle our emotions can be so it shouldn't be surprising that investor sentiment is a fast variable.

Given we want to put the most weight on slow variables in deciding our investment portfolio structure, we first review market valuations to determine the investment season for various markets such as the U.S., Europe or emerging markets.

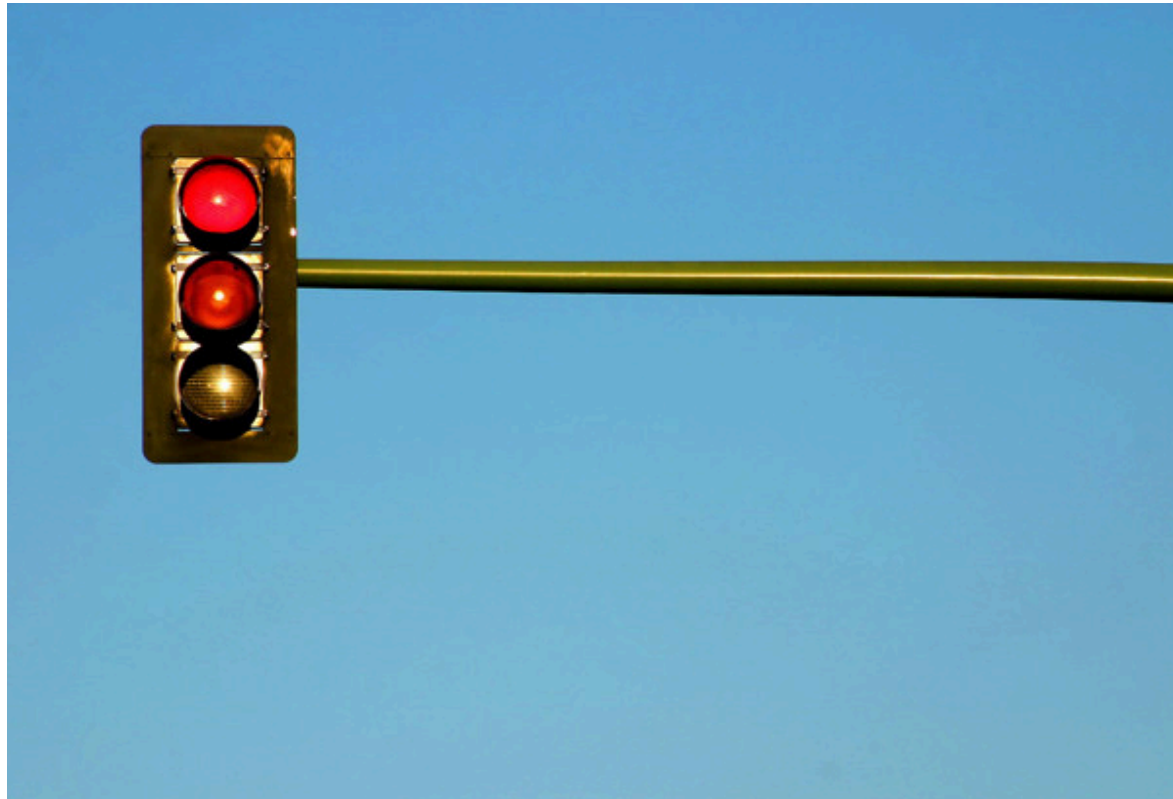
If market valuations are attractive suggesting we are in an investment summer, we would consider shifting assets from home base into more volatile investments that have higher expected returns.

Before making that shift, however, we review our second slow variable, the prevailing economic winds to see if there is a headwind or tailwind.

Finally, we look to investor sentiment to provide additional insight.

## Investment Rule 8: Follow the Traffic Lights

Market valuations, economic analysis and investor sentiment can be thought of as traffic stoplights that are each individually flashing red, green or yellow. If all three are red as they were in September 2008, we would be extremely cautious and stay close to home base with a higher percentage of our assets at in cash.



If they are all green, some investors might be willing invest upwards of 60% of their investment portfolio in stocks.

It would be rare to invest more than 60% in stocks because of dragon risk or unexpected events that could cause markets to change unexpectedly.

Just as a forest fire can suddenly ignite and sweep through an ecosystem, markets can experience a similar contagious disturbance such as a flash crash that sends the stock market plummeting.

Usually there is a combination of red, green and yellow lights, which leads us to put more weight on the slow variables of market valuation and economic analysis.

At the end of the day, there is no magic formula for deciding how to allocate assets in an investment portfolio away from home base. It is simply a process of looking at the incoming data and using our best judgment, always being mindful of dragon risk.

The good news is the success this investment approach is not dependent on making specific predictions. We just try to stay in-sync with existing trends and monitor changes that could warrant an adjustment in our portfolio.

Slow variables by definition evolve slowly, so our movement away from home base is generally done in a measured, incremental manner.

With this investment approach, there is no need to trade daily or weekly. In fact, my clients who use this approach usually only make portfolio changes once or twice per year.

Some clients prefer to make changes even less frequently and keep their portfolio allocation close to their home base risk-neutral position the majority of the time.

Since home base is set at a level where we avoid catastrophic portfolio losses, we can be patient investors and wait for favorable investment conditions without feeling like we have to be fully invested in the market.

I find this investment process far easier and less stressful than trying to select individual securities where so many things could go wrong because I have to accurately predict the future.

Likewise, I prefer it over a buy and hold investment strategy, which entails having the fortitude to suffer through large losses in hopes that they will be more than offset by portfolio gains.

### Investment Philosophy

I recognize these ten lessons are insufficient to cover all the ins-and-outs of this investment approach. My aim is to introduce the investment rules that comprise my investment philosophy for how to manage money.

Many individuals won't have the time or interest to pursue investing in this fashion on their own. Instead, they might prefer to have me create customized investment plan for them. You can learn more about that at <http://www.jdavidstein.com/advice.html>.

In Investment Rule 9, we will review what types of specific investments to utilize to access to undervalued baskets of securities.

## **Here's a checklist summary of today's lesson:**

- Market valuation, economic analysis and investor sentiment are the three major tools for determining how to shift a portfolio from home base into investments with higher expected returns.
- Market valuations and economic winds are slow variables in that changes in their general trends can take months. We put more weight on these.
- Investor sentiment is a fast variable as investor emotions can change quickly.
- These three tools can be thought of as traffic stoplights that are each individually flashing red, green or yellow.
- Slow variables by definition evolve slowly, so our movement away from home base is generally done in a measured, incremental manner as we seek to stay in-sync with favorable trends.

# *Investment Rule 9*

*“Over the long-term, the primary driver of portfolio return is the mix between cash, bonds and stocks and how it is adjusted over time.”*

## Diversify Your Baskets

In Investment Rule 8, we learned how market valuations, economic analysis and investor sentiment are like traffic lights, flashing red, green or yellow. By focusing first on the slow variables of market valuation and the direction of the economic winds and then fine tuning with investor sentiment, we can take a measured, incremental approach to allocating our investment portfolio.

In this chapter, we will discuss the types of holdings to invest your money in so you can access undervalued baskets of securities.

## Baskets are Assets

If you recall from Investment Rule 5, when conditions are favorable, we want to invest in diversified baskets of undervalued securities that are embedded with positive surprises, none of which we have to predict beforehand. We equated this to catching popping corn.



By baskets of securities, I mean asset categories.

Asset categories are segments of the market for which we can get some type of valuation metric. This can be both stocks and bonds.

Examples include U.S. small company stocks, investment grade corporate bonds, emerging market stocks, emerging market bonds, etc.

The three major broad asset categories in order of ascending expected volatility or range of returns are:

- **Cash** – which includes money market accounts, stable value funds, U.S. Treasury bills, etc.
- **Bonds** – which are fixed income instruments whose primary return driver is interest income. They include U.S. Treasury bonds, corporate bonds, mortgage-backed securities and international bonds.
- **Stocks** – are equity instruments whose primary return driver is capital appreciation, although there may be an income component in the form of dividends.

The primary way to access these asset categories is through mutual funds and exchange traded funds (ETFs).

Exchange traded funds are commingled funds similar to mutual funds except ETFs trade throughout the day like stocks while mutual funds only trade at the end of the market day.

A primary advantage of exchange traded funds is their expense ratios (i.e. fees) are usually lower than the average mutual fund.

## Avoid Concentration

Recall the goal is to get access to diversified baskets of undervalued securities that are chock-full of positive surprises, none of which we have to predict beforehand.

Positive surprises lead to market appreciation. Consequently, we want mutual funds or ETFs that ideally have hundreds of securities in them. We don't want

performance to be undermined by a manager trying to add value through concentrated security selection.

Concentrated portfolios require the fund manager to make specific company predictions. That is incredibly difficult as we learned with Investment Rule Three. The more specific the prediction, the more likely it is to be wrong.

Over the long-term, the primary driver of portfolio return with this investment approach is the mix between cash, bonds and stocks and how it is adjusted over time.

Since stocks add so much capital appreciation on the upside, while potentially causing severe losses on the downside, most of my analysis of market valuations, economic winds and investor sentiment is focused on stocks.

It is remarkable the performance contribution that can come from avoiding large losses in the stock market while participating in gains. Methodically adjusting the mix between stocks, bonds and cash based on the investment season and market conditions provides that opportunity.

## **Investment Rule 9: Diversify Baskets**

By investing in mutual funds and/or ETFs which hold hundreds of securities each, we can construct a thriving investment portfolio with 8 to 12 mutual fund/ETFs or less.

The goal is to have a variety of basket types so that we aren't dependent on one asset category to drive all the return. Maintaining a mix of baskets also minimizes losses if there is a contagious disturbance in the market.

So yes, while Investment Rule 1 is Stop Using Institutional Hand-me Downs, one institutional principle we should embrace is diversification.

In the next chapter, I will share a final rule on how to invest.

**Here's a checklist summary of today's lesson:**

- When conditions are favorable we want to invest in diversified baskets of undervalued securities that are embedded with positive surprises, none of which we have to predict beforehand.
- Baskets are the same thing as asset categories, segments of the market for which we can get some type of valuation metric. This includes both stocks and bonds.
- Mutual funds and exchange traded fund (ETFs) are the primary way to access baskets of undervalued securities.
- If possible, investors should use mutual funds or ETFs that have hundreds of securities in them so that performance is not undermined by a manager trying to add value through concentrated security selection.
- By investing in a variety of basket types, our investment portfolio is less dependent on one asset category to drive all the return. Maintaining a mix of baskets also minimizes losses if there is a contagious disturbance in the market.

# Investment Rule 10

## Don't Burn Your Ships

*“The most effective way to deal with complexity is to stay firmly fixed on the leading edge of the present - that thin line that separates the now from the unpredictable future.”*

In Investment Rule 9, we explored how we can access diversified baskets of undervalued securities by investing in mutual funds and ETFs with hundreds of securities in them. We also reviewed that by investing in a variety of basket types, our investment portfolio is less dependent on one asset category to drive all the return. Maintaining a mix of baskets also minimizes losses if there is a contagious disturbance in the market.

Investment markets are incredibly complex. Between irrational investors, changing economic winds, ongoing competitive battles, and fickle governments, it is no wonder that investment advice not only seems contradictory at times, but is often flat out wrong.

Similarly, this complexity is why professional investors so often disappoint.

The most effective way I know to deal with complexity is to stay firmly fixed on the leading edge of the present – that thin line that separates the now from the unpredictable future.

By staying in-sync with current market, sentiment and economic trends, with a particular focus on the slow variables of market valuations and the economic

winds, we can position our investment portfolio to take advantage of the future as it emerges without attempting to predict it.

## Burning Ships

In 1519, Hernan Cortés landed with a fleet of 12 ships near present day Veracruz, Mexico. The flotilla held 500 Spaniards, 300 natives, a dozen horses and a few cannons. Cortés' aim was to conquer the Aztec Empire and take possession of its great wealth.

The legend is that before launching the attack Cortés burned his ships to prevent his men from retreating. Through the ages this brazen act has come to represent fully committing to a course of action. Going all in. Burning all bridges.

The legend is also wrong.

It turns out Cortés had nine of the twelve ships sailed into the sand, grounding them. There is no word on the other three ships.

According to Hugh Thomas in *Conquest: Montezuma, Cortés and the Fall of Old Mexico*, the burning ship error derives from sloppy handwriting.

Two Spanish words were confused in the written record: *quebrando* (breaking) and *quemando* (burning).

Cortés was successful in his conquest, but one wonders if he intended to use the three unharmed ships as a backup plan in case the expedition didn't go well.



## **Investment Rule 10: Don't Burn Your Ships**

About ten years ago, I used to take an annual trip to meet individually with Seth Klarman of the Baupost Group, who is one of the most skilled investors I know. He managed a significant amount of money for one of my clients. My visits with Seth were incredibly rewarding because of his investment insight.

Seth wrote an investment book that has since gone out of print, but remains in high demand, selling used on Amazon for about \$700. It is titled Margin of Safety.

Keeping a margin of safety is another way of saying Don't Burn Your Ships.

We never want to invest so that a sudden reverse in favorable trends could decimate our portfolio. It can snow in July, just as it does on rare occasions at my Teton Valley, Idaho office.

Dragon risk is real and it can be deadly if we have too much of our investment capital exposed. Individual investors are not institutions who get second changes if their portfolios suffer large losses. That is why we are methodical, deliberate and patient in shifting assets from home base into asset categories with potentially higher returns.

## Trading

But what if you have a really great stock idea or you want to try your hand at trading?

Then by all means go ahead, but only invest an amount of money that you would be comfortable losing if you lost it all.

There is nothing wrong with speculation as long as you are prepared to accept the potential downside of speculation – which is permanent loss.

## Conclusion

I hope you have found this How to Invest Money ebook helpful. It is the foundation of my investment philosophy.

You can learn more about how to invest in this manner on my blog and newsletter, which you can find at <http://www.jdavidstein.com>. Or please email me at [jd@jdavidstein.com](mailto:jd@jdavidstein.com) with any questions.

**Here's a checklist summary of today's lesson:**

- An effective way to deal with the complexity of financial markets is to stay firmly fixed on the leading edge of the present – that thin line that separates the now from the unpredictable future.
- By staying in-sync with current market, sentiment and economic trends we can position our investment portfolio to take advantage of the future as it emerges without attempting to predict it.
- We maintain a margin of safety by methodically shifting assets from home base and never exposing all our investment capital to potential portfolio losses due to a sudden reversal in favorable market conditions.
- There is nothing wrong with speculation as long as long as we are prepared to accept permanent loss.