Remember The Fundamentals

December 2018

“Take a simple idea and take it seriously” - Charlie Munger

Larger movements in the daily stock market prices are back. The reports we read in the paper, hear on the radio, and see on the TV all say we should be doing something. The problem with the reports are threefold:

The news is good, not perfect, at reporting what happened. However, the news is not good at determining why it happened and how that changes the future.

- The news call to action assumes “they” know who “we” are.
- Human nature studies say we have a difficult time tuning out the noise and resisting temptation to just do something in order to feel better.
- To combat these temptations, we find it helpful to revisit the "simple idea" of investing. Why are "we" even doing this?

Simple Formula

Earnings - Expenses - Savings = Investing

The fundamental reason for investing arises from this simple formula which may seem too simple to be accurate. Many people either forget or speed by without noticing and giving it the attention it needs. However, as we discuss below, this formula is the engine that makes the investing process go.

Serious Calculations

As the formula implies, investing is what's left after earnings are received, expenses are paid, and savings for short-term shortfalls have been set aside. Inherently, there was a decision to use these excess earnings to meet a future goal. In addition, because of this decision, investors would like to receive compensation for not using the funds immediately. Companies and governments always work to provide that compensation. These institutions need the money to fund current operations, so they are happy to give investors promises for compensation. There are different types of promises (i.e. investments) to choose from. This is where we, your personal chief financial officers, help match the investments with your future goals. The calculated bet is that these companies and governments over the long-term are going to earn money at a rate that compensates you for foregoing spending. Seems simple enough.

Where do we see investors get this wrong? They inaccurately estimate their earnings, expenses, or savings goal. This causes investments that were earmarked for future goals and matched with "future promises" to be converted to current day prices. All of a sudden current market whims matter. Investors could get lucky and get good prices. Or investors could get unlucky and get bad prices. Either way, the role of luck is playing a larger role now. Most investors are unaware of that.

The lesson is: be serious about your personal formula so the role of luck can be diminished. Can the calculation be done incorrectly? Yes. However, the goal is to reduce as many variables as possible to know where the risks are. How confident are you in the calculation: 50%, 75%, or 90%? What is the size of the shortfall if it is wrong? Is the difference something you could take from savings or reduce other expenses instead of pulling from investments? Maybe. Start thinking in these terms and you can begin to arrive at a better investing number.

Calculated Bets

This simple formula is at best a calculated bet. Some bets may be more certain than others, but they are all bets on the future. Even in broader terms, whether we acknowledge it or not, every action we take is a calculated bet. Some are closer to 100% accuracy, so we take them for granted. My kids think if they get out of bed by 7:05 am every school day, they will be sitting at their school desk by 7:40. Most days it happens like clockwork. However, they do not understand the bets they take in order to ensure this happens. If the car does not start and there is no extra time to walk, they are late. If they forget something and need to turn around, they are late.

The point being, humans (including Anna and Drew) for many efficient reasons are naturally inclined to operate in certainties. If you took a few minutes, you can think of many things you take for granted when in reality, 100% is not a given. Maybe it does not change your decision, but by thinking in bets you should better understand the range of results. Not surprising this discussion has not changed my 12-year old's morning habits!

Investors are guilty of thinking in certainties too. Just because a corporation wants to pay a certain return does not mean that return will be the same everyday over the life of the investment. The stock market's recent daily movement is an indication of that. No one should make a career out of timing the market highs or lows. In reality no one (and we truly mean no one) gets the highs or lows of each market cycle correct, so trying is a poor calculated bet. Besides, if the funds are designated for investing by our simple formula, then there should be a long term goal for funds and short-term movement is less important.

Family Game Night

Annie Duke, in her book "Thinking in bets: making smarter decisions when you don't have all the facts" compares the games of poker and chess. In her opinion, the stark contrast boils down to one thing, the role of uncertainty. Poker has an element of uncertainty and incomplete information on each hand. Chess contains no hidden information and very little luck. If played perfectly, a draw is all but ensured in the game of chess. If there is a winner, it is due to an opponent's blunder.

Many investors incorrectly assume that investing is like the game of chess. These investors spend too much energy searching for the one and only perfect move. They believe if they do not find the answer, they will be ridiculed for making the unforced blunder. However, there is just too much uncertainty in stock market movements to know exactly what the immediate future will look like. Could your amateur poker playing friend beat a world champion poker player in the short-term? Yes. Could your amateur investor friend outperform Warren Buffett in the short-term? Yes. Does that mean the amateur knows what they are doing? No. If given enough time, would Warren Buffett and the world champion poker player most likely win? Yes. The lesson is investors end up with bad experiences sometimes because they misunderstood the game they were playing.

At your next family game night, if you are forced to let either a professional poker player or professional chess player join, choose the poker player. You can get lucky on a few hands in poker. If you get lucky early make sure to kick them out of the house quickly because eventually the odds will tip in their favor with more opportunities. You have no chance against the chess player :)

Moving Forward

As we bring another calendar year to a close, it is a good time to look back. Was 2018 in line with earnings, expenses, and savings expectations? If not, do these variances need to be factored into future periods? Do we need to adjust our calculated bets? Factoring in various market expectations, we want to give you and your family the best probabilistic chance at success. Please contact us if you would like to discuss your personal situation.

In the spirit of the season, we want to thank you for being an incredible group of clients. We strive to work with a small group of families in which we can have a big impact. That usually means spending lot of time discussing all the things that are important to you. We do not take that for granted and we take this simple step seriously in order for our clients to make informed decisions about their money.

From the entire McCarthy Grittinger Financial Group team, we want to wish everyone a great start to this holiday season. If someone you care about would benefit from this newsletter, please feel free to pass along.

---

[1]http://uwm.edu/business/academics/investment-management/

[2]https://www.nar.realtor/newsroom/house-tax-bill-delivers-tax-hike-on-homeowners

[3]http://www.nytimes.com/2008/10/17/opinion/17buffett.html

Scott D. Grittinger, CFP®
Matthew T. Miler, CPA, CFP®
Jacqueline A. Schneider, CFP®
Amy L. Finley, CFP®
Alicia A. Nordwig, AAMS®
Maggie Mayer
Jacob Hornak