INSIDE-OUT INVESTING FOR LONG-TERM SUCCESS

September 23, 2023 | by Brian J. Regan

Do you want to be a great investor but consistently struggle by selling at the wrong time and subsequently failing to get reinvested? You're not alone. Here is a guide to smarter investing!

Becoming a more successful investor isn't easy. But it can be easier if you're an Inside-Out investor. Being an Inside-Out investor means starting with how you are on the inside. Your emotions and feelings about money are important to consider. Then you work outward to more concrete principles of long-term planning, asset allocation, and consistency in investing.

The Inside

What is enough for you? Goal-based planning is first about determining your personal "enough." Goal-based planning then helps inform the amount of risk you can take in your investment portfolio. The closer you get to "enough," the less risk you should take.

To this end, I like to think about Morgan Housel's popular book, *The Psychology of Money*. Housel writes that you should think about what is "enough" for you. What is "enough" money to achieve the life that would make you feel satisfied? It's important to have an idea of this so you know what you are saving and investing for, but also so you know when you have reached the finish line. Knowing when you reach the finish line keeps you off the hedonic treadmill. It allows you to be happy. It also lets you know when you can take your foot off the investing gas. You only need to get rich once.

That's the "Inside" of the "Inside-Out" mentality. As we start to move further "Out" we need to get more logical rather than emotional. The further you get out, the further you get into the details, the more fiercely logical you need to become. You leave your family, politics, religion, sports teams, and social media influencers on the inside.

The Outside

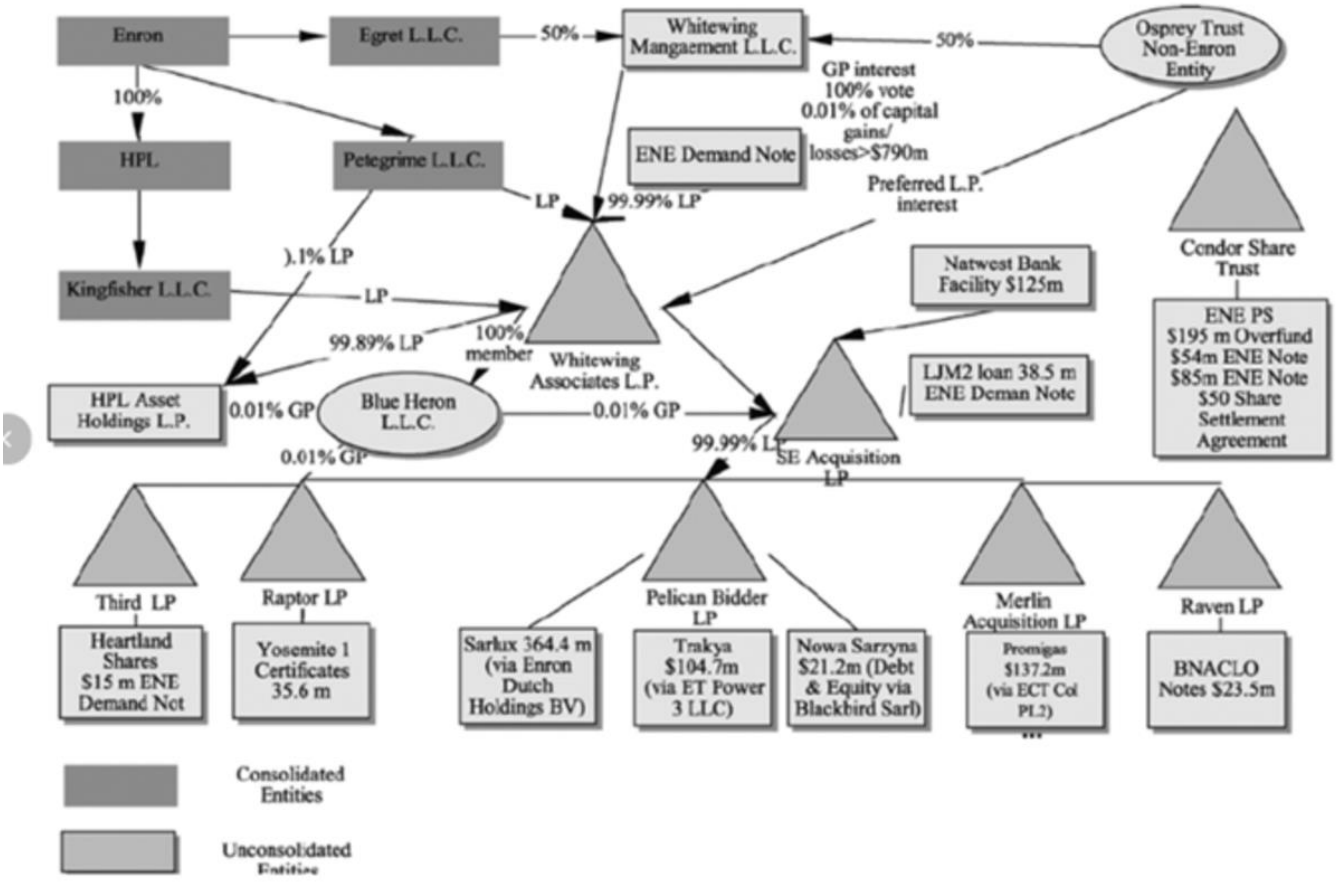
Think of the future. Almost all investors should have a long-term horizon. I have said this to 90-year-old people with terminal diseases. Laughter ensued. The reality is that that person is not investing for themselves anymore; they're investing for their heirs or for philanthropic ventures that likely have very long horizons. In March of 2022, the market was not doing well. I wrote an article stating that it was time to evaluate asset allocation, consider rebalancing and wait out volatility. The market dropped for seven more months but is now 10.2% higher. That would have outpaced a money market fund by 5.73% (SWVXX). Patience often pays.

Asset allocation: mix the right ingredients. It's important to note that any allocation to the money market fund and the stock market during that period of March 14, 2022, and today would have been successful. The key is sticking to whatever combination of assets that allows you to stick it out for the long term. These are two extreme examples of assets. The S&P 500 is very volatile and unpredictable in the short term, while a money market fund is conversely predictable in the short term without volatility. You can mix investing ingredients that provide a risk/return profile that works for you in the long term.

There are all sorts of different types of investments that trade. The debt of a U.S. steel manufacturer is very different than the equity of a Swedish music platform company. Every asset has a value even if that value is often zero. As an added benefit, the equity value of global economies rises with time, and debt

assets are legally obligated to pay out. I truly dislike when people say they are "playing the market," but insofar as you want to consider the act of investing a mere game, the investor is the house.

Know Your Investments. It is much easier to determine value, build an allocation and stick to the long-term with assets that you comprehend. Enron was famously a complex organization that was a fraud.



Example of Enron's complex SPE structures. (Redrawn from Swartz and Watkins (2003).

I am here to stress that fraud-like activity is not rare, even if it is not always illegal. If you understand the assets you're buying, it's less likely you'll fall into these traps. Luckily, we live in a world where easily understandable and cheap assets (in terms of expense ratios) are the norm, such as index and money market funds.

Buy low, sell high? Not necessarily. Many people intuitively understand that they should buy low and sell high. But how do you know if you are buying low or selling high? You need to set a value for the asset. The value of the asset to you likely will be different than the value of the asset to the market.

Every business school in the world teaches a discounted cash flow model, or DCF. The value of the asset under that model is significantly dependent on the assumed rate of return. Every junior, senior and MBA candidate right now is learning how to determine the appropriate market rate of return. But imagine you did not want to generate the market rate of return. What if you decide that you don't want to invest in any stock that won't generate an annual expected return of 20%? What if you realized that there are a lot of assumptions in this model and if you wanted to create a margin of safety, you should set your rate to 20%

(or higher)? I'll do everyone in school a favor – there is no reason you cannot require or achieve a 20% expected return.

Economists would have you believe that this approach is not possible. They believe the market is a perfect arbiter of price, and if you did such a thing as to demand a higher rate of return on your equity, you would find nothing to buy — or that your assumed cash flows must be wrong. I have news for those economists: the cash flow assumptions are definitely wrong — they're merely estimates of the future — and you'll likely find something to buy. The market is not a perfect arbiter of stocks. In Warren Buffett's words, "Mr. Market is a Drunken Psycho where some days he gets enthused and some days he gets depressed." The Drunken Psycho will offer opportunities to get your rate of return, and you do not need to be too patient because he's often losing his mind somewhere, if not everywhere.

Stay consistent and keep growing – like a relationship. I'm dishing out dating advice now (as an allegory for stock picking). When you start seeing someone new, it is a good idea to consistently dress well, smell nice and have a stellar personality. You may have trouble getting a second date if you are unclean and boring. It is also a good thing to be persistent. People often want persistent conversations to continue after the date to stay excited about the dating prospect. Finally, people typically want the relationship to grow from small talk to medium talk and, someday, serious talk.

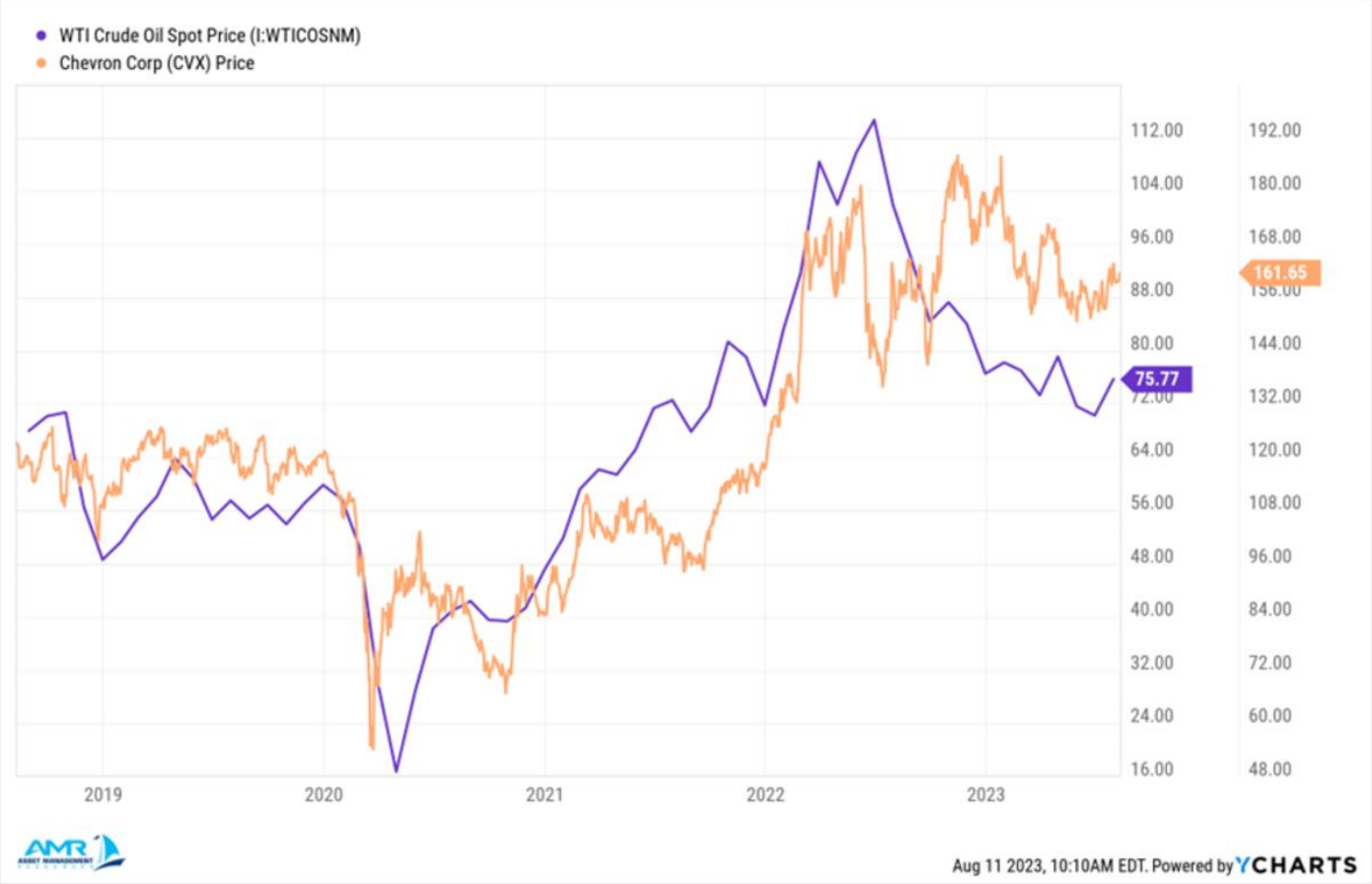
I guess I "date" my stocks because that's a similar relationship I have with them, albeit without much emotional attachment. I mentioned the DCF previously. A large problem with the DCF analysis is the assumptions that need to be made for future cash flows and growth. If the cash flows can consistently be estimated and persistently perform with growth, then you will have a better estimate of value and likely be willing to pay more than typical market metrics and possibly achieve better returns.

Stay cool: don't follow the crowd. If investors can manage to stay rational to this point, then they can likely do very well. However, I have a belief that many novice investors go straight to the hype cycle with enthusiasm, rather than a calculating coldness that is likely necessary.

As Warren Buffett taught us, Mr. Market is a Drunken Psycho who sways by his irrational feelings in the short term. We have had many examples of this type of behavior that I have written about here. Investors need the discipline to ignore the social pressure and noise that can stem from hot topics.

Separately, but maybe even harder, are mispricing in cyclical assets. Often, boom times in companies can be extrapolated out into the future when the industry is cyclical, or barriers to entry are low, meaning forward cash flows likely won't justify the current price. The opposite can also be true. When cyclical businesses are on the downtrend, it can be assumed that it will be the case forever, but some competitors will fall off and demand may come in at the lower price. The buying opportunity likely comes when things are bleak. You can see in the chart below that the buying opportunity for Chevron was when oil prices were at their weakest... but that presumed oil prices would stay at their low levels.

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Conclusion: Success is possible!

Investing successfully is challenging, but it is not impossible. It is difficult beyond the fact that the nuts and bolts of investing can be hard to comprehend. It is mostly difficult because of the emotional intelligence it demands. My aim for this "Inside-Out Guide" is to be a bit of a playbook. The progression leads to a comprehensive strategy that incorporates emotional awareness, informed decision making and even the ability to identify mispriced assets and steer clear of manias. Successful investing requires emotional intelligence and logical thinking. It is easier to be fiercely logical if the emotional demands are addressed. Finally, to do very well, you do not need to get beyond "Know Your Investments"! So, master the basics and if you're the ambitious type, calm your emotions and dig into the details — it may be more rewarding!

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