FINANCIAL PREPAREDNESS

"One of life's most painful moments comes when we must admit that we didn't do our homework, that we are not prepared." ~ Merlin Olsen

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Admitting One's Mistakes

Like life itself, investing can often be a humbling endeavor. Since price volatility comes with the territory, it's common to suffer an (unrealized, hopefully temporary) capital loss after you buy an asset. It's like getting a strike when you go to bat in baseball. Since this is no surprise, you shouldn't get wrapped around the axle about it. In fact, if you scale into positions like I do, it can be an opportunity to accumulate additional shares at more attractive prices. As such, this is not something you should fear, much less lose sleep over.

What you *should* fear is the misfortune known as a "permanent impairment of capital," because this is very difficult to recover from, especially if the loss occurred in a sizable position. Eventually, all companies go bankrupt, so all stocks will go to zero. Bonds can go to zero (or close to it) if the borrower defaults or there is very high inflation. Even hard assets like real estate and precious metals can go to zero if the government confiscates them (as will happen with many properties in New York City in the years ahead) or makes it illegal to own them (thanks to FDR, it was illegal to own gold in the Land of the Free during much of the 20^{th} Century).

But an investment doesn't necessarily have to become worthless for you to suffer a permanent loss of capital; there are plenty of other ways this can happen, including:

- Investing heavily based on a well known story (e.g., the Internet, the housing boom, fracking, AI, etc.)

- Allowing your emotions to drive your investment decisions.

- Impatience.

- Investing without doing enough research (which is virtually all retail investors).

- Not monitoring your investments after you buy. Here I'm not talking about the asset's return, but its underlying financial performance. A lot of things can go wrong after you buy.

- Unexpected political, legislative or regulatory developments.

- Discovering that a company is being managed to achieve the goals of the United Nations, the World Economic Forum, environmental activists or social justice warriors instead of to maximize shareholder value.

- Accounting fraud by management.

- The failure to increase a dividend each year, which often leads to the reduction of the dividend, which then often ends with the elimination of the dividend.

- Permanent loss of a major customer, or loss of access to a vital input or important market.

- Putting your eggs in too few baskets.

- Making predictions that turn out to be completely wrong.

- The market remaining irrational for longer than you can remain solvent.

- Investing with borrowed money or other forms of leverage (e.g., options, leveraged ETFs, etc.).

- Major swings in foreign currency exchange rates.

All of these could easily result in a major, permanent loss of capital that could take a very long time to recover from (if ever). Especially due to the way the math works (e.g., a 50% loss requires a 100% gain to get back to even).

One way to limit a loss before it becomes a permanent loss of capital is to (1) admit to yourself that you made a mistake (or simply had bad luck) and (2) do something about it (such as liquidating your investment). Psychologically, this is extremely difficult to do because your ego is primarily tasked with defending your reputation, including to yourself. So it will tell you stories like “It will recover soon, and then you can sell” or “It's not a loss until you sell."

The problem with not liquidating an investment that will probably never recover is that the remaining value of the capital that you have tied up in it is essentially dead money, so may never produce a significant positive return. This is what's known as a "possible value trap" (as opposed to an asset that is simply out of favor and thus undervalued). It may make more financial sense to sell the asset and reinvest the proceeds in another asset that has a higher expected return (based on valuations and sentiment, not on high recent returns).

In conclusion, being willing to admit to yourself that you made a big mistake (or just had terrible luck) and then doing something about it requires self-awareness, maturity and rational thinking that most investors simply lack. Psychologically, it's more comforting to ignore the problem and hope for the best at some point in the future, but that often comes at a cost of dead money earning little or no return.

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