



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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Incremental Investing

I recently wrote about [dosage](#). When it comes to investing, dosage (the size of each trade and how often you trade the same security) can matter just as much as *what* you trade.

Most individual investors who actively manage their own portfolio are probably macro (top down) investors who rely on [stories](#) (from the financial media, [the Fed](#), brokerage firms underwriting new securities, various governments, and institutional investors talking their own book) economic reports (many of which are produced by government agencies, the purpose of which is not to provide accurate economic data to market participants but to help incumbent politicians get re-elected) and their own intuition to come up with ideas for trades.

Usually such trades are large (at least 5% of their portfolio, possibly up to 100%), placed all at once at the market price (when one's ego is driven by greed and lack of humility, there's no time to use limit orders that may never fill), devoid of any risk management concerns or demand for income, poorly researched (a story alone justifies the trade), lacking a longer-term historical context, and not well thought out. The inevitable result is highly concentrated positions and thus a very large amount of unsystematic risk (which could have been eliminated through diversification), volatile returns, little or no income, often a lack of cash that could be used to take advantage of life-changing opportunities, a lot of

stress and sleepless nights, and unpredictable but subpar returns.

In contrast, the process I use to deploy capital was developed and refined over three decades of managing portfolios professionally, often after making some painful mistakes. My process is based on a number of principles.

First, respect for my clients' capital. This is money they earned and saved over many years after working hard, making sacrifices, delaying gratification and taking risks. Their wealth is scarce and powerful life energy. I take that responsibility seriously, just like I took seriously the job of running a live-fire range when I was an Army officer. My old battery commander would say that we train so that we can do dangerous things safely. Managing portfolios is like running a range all day every day. It's a lot more dangerous than it appears (as many investors have learned the hard way), as things can suddenly blow up when you least expect it.

Second, humility. I don't know what's going to happen, though as a student of history and human nature, I think I generally know how the movie will end. Legendary investor Jim Rogers said, "Securities prices can go far higher and far lower than you can ever imagine." The odds that I will buy a security exactly at the low price and sell just as it hits a high price is 0%. The price can *always* go higher or lower. And it doesn't need to make sense, either. As the saying goes, "The market can remain irrational for longer than you can remain solvent."

Another potential risk that value investors such as myself face are value traps, which are companies that appear to be bargains but are cheap for a reason. This usually becomes apparent only with the passage of time.

And even though I have access to an unprecedented amount of information about companies (though my time and energy to process it all is still very much constrained), it's still only a fraction of the entire ground truth. Corporate managers have strong financial incentives (keeping their job and maximizing the value of their company stock and stock options) to conceal or delay the disclosure of information that would cause the value of their company's stock to decline.

So instead of placing big trades at the market price, I scale in over time using limit orders (lowball for buys and premium for sells). This is similar to dollar-cost averaging (DCA), a practice used by many prudent but agnostic individual investors who know they need to save and invest but don't know when to buy. DCA involves periodically investing a fixed amount of money in the same security (usually a mutual fund) over time, at whatever the prevailing price is. This results in you buying more shares when the price is low and fewer shares when the price is high, which reduces your average cost per share. Buying the same security at different points in time also allows you to achieve *time diversification*.

The third principle is caution/wariness/skepticism. I want to nibble over time in a circumspect way, not enthusiastically swallow a juicy story hook, line and sinker. There's a lot of deception, malfeasance and fraud on Wall Street, so you need to play this game with your eyes wide open and your hand on your wallet.

The fourth principle is [patience](#), which I think is the best virtue an investor can have. Investors (especially those who invest in equities) really need to take a long-term view and zoom out, instead of say checking on the price of a security throughout the day or the value of their account every day. Your return is not a function of how often you check a price or value, it's just your bored brain trying to get a dopamine hit.

It took the U.S. stock market 25 years to recover from the crash in 1929. (BTW, you do know that the current [Shiller P/E ratio](#) is now far higher than it was at the peak of the market in 1929, right?) After you buy a security, it could take many years for you to earn a decent return or simply break even. Investing incrementally respects how the necessity to wait is similar to wading through a vat of tar; generally, you can get rich over time, but not quickly.

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