Step 6 - Select financial investments rationally

Category : Financial Planning -- 10 Personal Steps in the Right Direction

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Select investments rationallyStep 6 of "10 Financial Planning Steps in the Right Direction"CLICK HERE TO READ *THE SKILLED INVESTOR*'s OTHER ARTICLES ABOUT THESE "10 FINANCIAL PLANNING STEPS IN THE RIGHT DIRECTION Given the extremely large number and variety of available securities, investors need a rational basis to select among them. Without rational selection criteria and a good understanding of which factors are more or less likely to increase risk-adjusted returns, investors will make decisions based on false assumptions. *The Skilled Investor* has concluded that all forms of active management that cannot be cost justified should be driven out of personal investment strategies. Individuals need to choose a comfortable, low cost, low tax, risk-adjusted market investment strategy and let it run over time. Maintenance should be minimal and low cost, and the urge to chase “beat the market” mirages should be heavily restrained. Investors’ strategies should focus on broad-based, market-oriented securities that can be acquired economically and held inexpensively for an extended period. Markets blend the speculative, future-oriented value assessments of a wide variety of investors of differing outlooks and opinions. The current price of a security represents the market’s risk-adjusted consensus about its potential future value, given the various advantages and disadvantages that all investors see in holding or selling that security. Three key concepts are important to consider when deciding on a rational basis for choosing investments. First, the current price of a security represents the market’s consensus about its potential future value, given the various advantages and disadvantages that all investors see in holding or selling that security. As such, the current security price is a weighted average valuation forecast of events that might or might not occur. Market prices are the best available assessment of forward-looking, risk-adjusted fair market value. Through the market price, a wide array of investors with differing predictions and varying concerns essentially “vote” on the expected or likely future value of a security through the current price. Investors’ evaluations of the value of securities may vary widely. What one person might see as a great bargain, another might consider grossly overpriced. Second, securities prices represent the current valuation consensus on a risk-adjusted basis. Risk refers to the expected size and likelihood of future up or down price variations or volatility. As such, not only do prices reflect expected returns, they also reflect the panoply of concerns, optimism, risks, and euphoria about how a wide range of factors might affect the price in the future. Third, given this highly speculative, future-oriented, and risk-adjusted valuation process, there are bound to be very significant price fluctuations as time goes on. This variability is the natural side effect of the market’s communal, self-interested valuation process and is neither good nor bad. It seemly means that speculation about future investment value is subject to risk and uncertainty. The problem with trying to predict future securities market values is that the future is fundamentally unknowable, until it arrives. While history can be instructive about what might be more or less likely in the future, history tends not to be predictive. Securities prices exhibit only a very tiny level of predictability within a very large range of random fluctuations. The blending of expected returns and expected risks into prices means the situation is subject to a wide range of either insightful or specious observations. The movement of historical prices across time provides an opportunity for just about anyone to develop a supposedly predictive theory on how the markets actually work and to offer some selected data in support. The only reliable way to sort through what is true or false about such predictions is to rely

upon the studies of highly disciplined academics who carefully test these theories against historical market data. *The Skilled Investor* has concluded that individuals will probably be better off, if they ignore concerns about whether markets value a particular security fairly. If there is a reasonably large and liquid market where investors interact through “arms length” transactions, then individual investors should accept the market price and avoid the usually futile exercise of second-guessing it. Instead, investors should focus their efforts on: ->becoming better educated about investing rather than just relying naively upon advisors to do the right thing for them ->earning income and saving adequately to fund their investment program ->understanding their relative risk tolerance and choosing a risk appropriate asset allocation ->using rational selection methods to acquire a low cost, low tax, broadly diversified, passive market-based portfolio ->applying time and energy to investment activities that tend to increase personal financial welfare, while eliminating time spent on activities that undermine it. *The Skilled Investor* provides a variety of articles that can help individuals to understand rational investment selection criteria. For example, see these articles on investment fund selection: ->Rational selection of bond mutual funds and equity mutual funds -- overview ->Choose mutual funds with lower investment management expenses ->Avoid mutual funds with sales commissions and 12b-1 fees ->Choose sufficiently mature mutual funds ->Choose mutual funds with a minimum economical portfolio size ->Avoid very large actively managed mutual funds ->Avoid mutual funds with higher portfolio turnover ->Evaluate historical investment performance, but only after using other investment screening criteria