RIA Advice

Managing your portfolio has more to do with gardening than you might imagine. Over the last decade, behavioral finance studied investor psychology and identified the repeated behaviors investors make throughout market cycles. As you can probably surmise, investors tend to develop many *"bad"* behaviors, which are the biggest reason for underperformance over time.+

Such was the topic of an article from [ARS Technica:]

> *?There?s extensive academic literature on the risks faced by investors who are overly confident of their ability to beat the market.* ***They tend to trade more often, even if they?re losing money doing so. They take on too much debt and don?t diversify their holdings.*** *When the market makes a sudden lurch, they tend to overreact to it. Yet, despite all that evidence, there?s* ***no hard data on what makes investors overconfident in the first place.?***

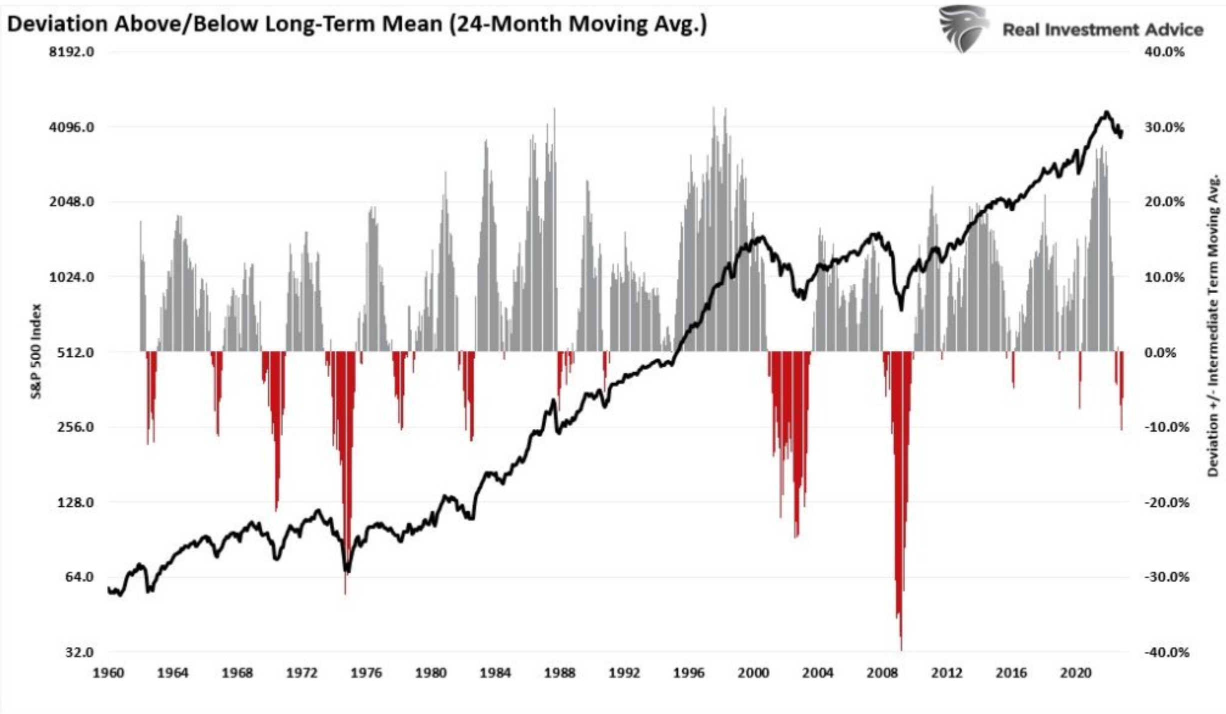
As we discussed in ***["Bull Markets & Why We Repeat Our Mistakes:"]***

> *"Behavioral biases that lead to poor investment decision-making is the single largest contributor to underperformance over time. Dalbar defined nine of the irrational investment behavior biases specifically:"*

- ***Loss Aversion ?*** *The fear of loss leads to a withdrawal of capital at the worst possible time. Also known as "panic selling."*
- ***Narrow Framing ?*** *Making decisions about one part of the portfolio without considering the effects on the total.*
- ***Anchoring ?*** *The process of remaining focused on what happened previously and not adapting to a changing market.*
- ***Mental Accounting ?*** *Separating the performance of investments mentally to justify success and failure.*
- ***Lack of Diversification ?*** *Believing a portfolio is diversified when it is a highly correlated pool of assets.*
- ***Herding?*** *Following what everyone else is doing. This leads to "buy high/sell low."*
- ***Regret ?*** *Not performing a necessary action due to the regret of a previous failure.*
- ***Media Response ?*** *The media is biased to optimism to sell products from advertisers and attract view/readership.*
- ***Optimism ?*** *Overly optimistic assumptions tend to lead to rather dramatic reversions when met with reality.*

> *"During bull market advances, 'herding,' 'lack of diversification,' and 'anchoring' are the most common problems. These behaviors tend to function together and compound investor mistakes.*
>
> ***'Bull markets hide investment mistakes. Bear markets expose them.'"***

As shown, *"reversions to mean"* remain one of the most powerful forces in investing.



So, what does this have to do with gardening?

Why Investing Is Like Gardening

Over time, the most prominent mistake investors make is failing to manage investment risk.

Individuals tend to do an excellent job of *"buying"* stocks. However, they are terrible at "*selling"* them. Of course, since the media only tells you to *"buy,"* such should not be surprising.

However, *"buying stocks"* is only one-half of the investment transaction. Unfortunately, individuals tend to *"sell stocks"* only after accumulating significant losses. Such is the very nature of the *"buy high, sell low"* syndrome.

Over the years, I have found that the concept of *"gardening"* tends to resonate with individuals in portfolio and risk management.

In the *"Spring,"* it is time to till the soil and plant your seeds for your summer crops. Of course, one must water, fertilize, and pull the weeds; otherwise, the garden won't grow. As the *"Spring turns into Summer," it's* time to harvest the garden's bounty and rotate crops for the *"Fall"* cycle. Eventually, even those crops must be harvested before the *"Winter"* snows set in.

While many investors are good at planting the garden, they often forget to harvest the bounty it produces. Such leads to the benefits of the garden rotting on the vine.

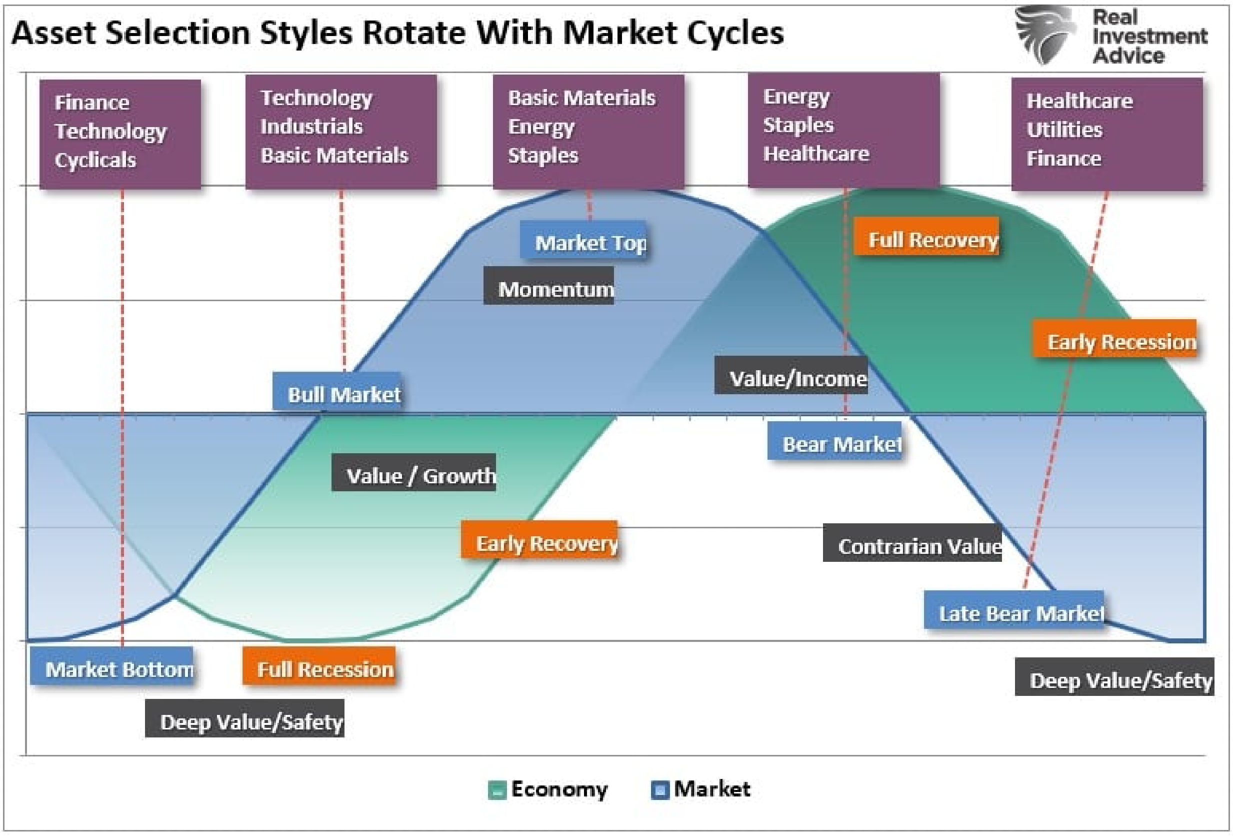
Being a good gardener, or *"having a green thumb,"* is not a function of *"luck,"* but rather carefully planned actions to ensure the garden grows, the bounty gets harvested, and the garden is replanted.

Steps To Follow For A "Green Thumb"

Therefore, to have a successful and bountiful garden, we must:

1. **Prepare the soil** *(accumulate enough cash to build a properly diversified allocation)*
2. **Plant according to the season** *(build the allocation based on the current market cycle.)*
3. **Water and fertilize** *(add cash regularly to the portfolio for buying opportunities)*
4. **Weed** *(sell losers and laggards, weeds will eventually "choke" off the other plants)*
5. **Harvest** *(take profits regularly; otherwise, "the bounty rots on the vine")*
6. **Plant again according to the season** *(add new investments at the right time)*

Like everything in life, there is a *"season"* and a *"cycle."* When it comes to the markets, *"seasons"* are dictated by the *"technical and economic constructs,"* and the *"cycles"* are dictated by ***"valuations."*** The seasons are shown in the chart below.



Currently, as noted above, the *"technical and economic constructs"* are warning us we are late into the *"Fall,"* and *"Winter"* is approaching. Such is why we are taking action to *"tend to our garden"* now so that we will prepare for the first *"cold snap"* of winter, or rather, a recession.

So, what actions should you take to prepare your garden for 2023?

Tending The Portfolio For 2023

As noted above, the first step in preparing your portfolio for what happens in 2023 is to clean up the things hindering you.

Step 1) Clean Up Your Portfolio

1. *Tighten up stop-loss levels to current support levels for each position.*
2. *Hedge portfolios against significant market declines.*
3. *Take profits in positions that have been big winners.*
4. *Sell laggards and losers.*
5. *Raise cash and rebalance portfolios to target weightings.*

The next step is to rebalance your portfolio to the allocation that will most likely weather a *"cold snap."* In other words, think about what sectors and markets do better in whatever economic environment you believe we will experience in 2023.

Step 2) Compare Your Portfolio Allocation To The Model Allocation.

1. *Determine areas requiring new or increased exposure.*
2. *Calculate how many shares need to be purchased to fill allocation requirements.*
3. *Determine cash requirements to make purchases.*
4. *Re-examine portfolio to rebalance and raise sufficient cash for requirements.*
5. *Determine entry price levels for each new position.*
6. *Evaluate "stop-loss" levels for each position.*
7. *Establish "sell/profit taking" levels for each position.*

> *(**Note: the primary rule of investing that should NEVER be broken is:** ?Never invest money without knowing where you are going to sell if you are wrong, and if you are right.?)*

Lastly, with a game plan, it is time to pull the weeds, till the soil, plant seeds, and water the soil.

Step 3) Have positions ready to execute accordingly, given the proper market set-up. In this case, we are looking for positions that have either a *"value"* tilt or have pulled back to support and provide a lower-risk entry opportunity.

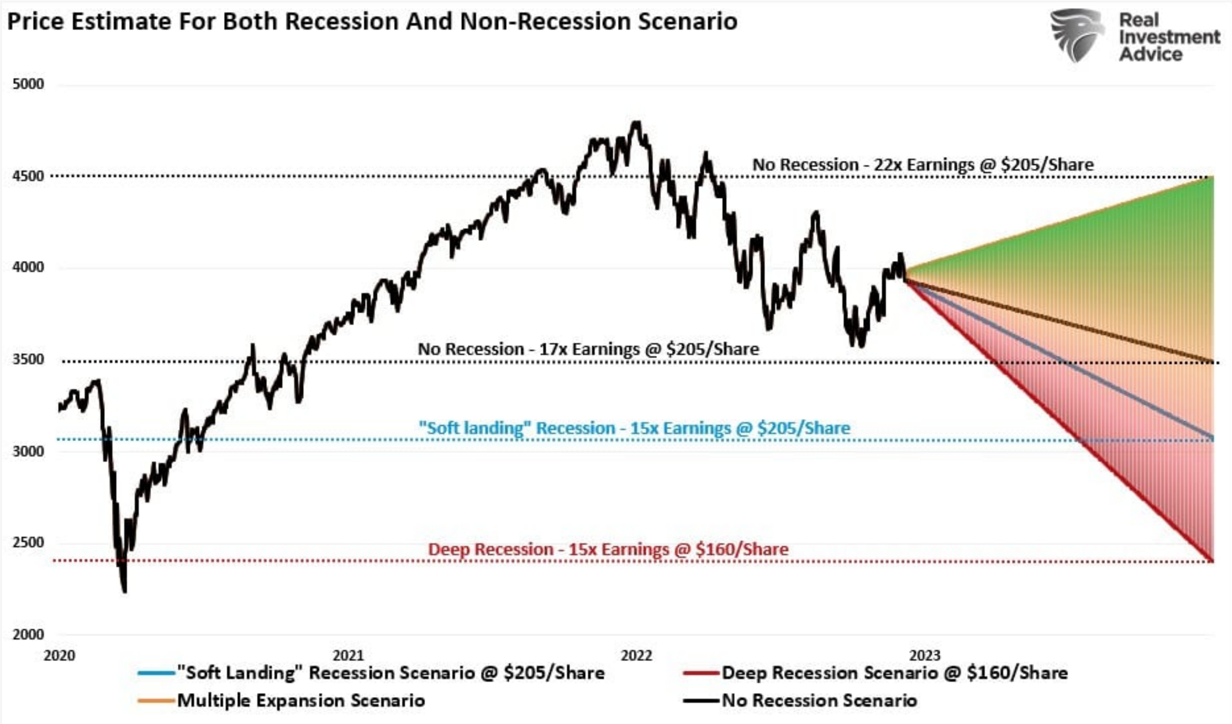
The Benefits Of Portfolio Management

These actions have **TWO specific benefits** depending on what happens in the market next year.

1. **If the market corrects further,** these actions clear out the *"weeds"* and protect capital against a further decline.
2. **If the market rallies,** the portfolio is stable, and new positions can be added to participate in the advance.

As we discussed in ***"Valuation Math Suggests Difficult Markets,"*** there is a wide range of potential outcomes for next year. Much will depend on the Fed's monetary policy changes and whether the economy slips into a recession.

"Our best guess is that reality lies somewhere in the middle. Yes, there is a bullish scenario where earnings decline, and a monetary policy reversal leads investors to pay more for lower earnings. But that outcome has a limited lifespan as valuations matter to long-term returns."



No one knows with any certainty how the markets will perform next week, much less over the next several months or an entire year.

We know that not managing "risk" to hedge against a decline is more detrimental to achieving long-term investment goals.

It doesn't take tremendous effort to tend to your portfolio garden. The mistake investors make is assuming that planting a garden today will produce its bounty tomorrow. That is not how portfolio management works. Taking action in your portfolio today may lead to short-term underperformance. However, in the long term, managing the portfolio to mitigate the risk of catastrophic losses will lead to a bountiful garden to support you in retirement.

While we continue to maintain some long equity exposure in our portfolios, we have *"harvested"* winners *(took profits)* and raised substantial cash levels in *"winter preparation."*

In the short term, this will provide some drag between our portfolio and the major market index if the market rallies. However, when winter's next *"cold snap"* washes across the markets, our preparation should protect our garden from "*frostbite."*

We remain "*bullish"* on the markets long term. The current *"bear market"* cycle will most likely end next year. Just as any farmer is keenly aware of the signs "*Winter"* is approaching, we are taking some precautionary actions to be prepared to replant for the next *"Spring"* cycle.