What Pain taught me about investing (1/2/13)

I first went into the stock market because it seemed exciting and it is but I have since learned that those who seek excitement from their investing activities are doomed to lose their shirt. This may indeed not be a failed venture for them if their primary objective was to seek excitement…they may indeed have found that which they sought, even if they didn't realize what they REALLY wanted when they began. If you doubt this view, just wander down to your local casino. People are paying for excitement there, most know they will lose but get a kick out of it anyway.

I have worked in the stock market most of my adult life. I have seen money made and lost and learnt from some very bright market operators including Rene Rivkin, Peter Guy, Shane Finemore, Erik Metanomski, David Paradice, Karl Seigling, Geoff Wilson and others.

Ultimately, I have found myself as a professional investor making a living from my modest capital and (as importantly) enjoying the process.

The object of today's article and indeed this series is to pass on some hard won and painfully earned wisdom. As both an investor and a publisher of a stock market newsletter in my history, I am overtly aware of the failings of most amateur investors when they venture into the market. In this series I will endeovour to pass on some of what I have learned in a series of rules…so lets start with WHY…

Investing is as potentially misleading and influential as a peer group to a vulnerable teenager. The market will seduce with its charm and paint rainbows with its false promises but without a valid investment strategy and the discipline to administer it, it is only a matter of time before the inexperienced investor loses capital and sometimes worse, their mental health. Without a valid investment process, it is only a matter of time before fear and greed influence your decision making…and that usually leads to losses.

A valid investment strategy is a set of rules that when implemented over time delivers risk-adjusted profits that suit the investor's goals, requirements and temperament.

The single most common mistake I have witnessed in the process of investing is the failure to create a valid and useable investment strategy. I am not going to go into all the details of how to create an investment strategy for you but it should be understood that investing is part art and part science. It is a trade (no pun intended) that is learnt over a long period of time and requires passion, diligence and consistency. You would not pretend you can repair your car, build your house, diagnose medical care etc etc without first learning how. Why then do so many people willingly dive into the markets with little to no preparation?

My simple response to that is they don't know what they are looking for in their investing. As I said before, the legendary trader, Ed Sakota once said, "Everyone gets what they want from trading".

The first and most critical question one should ask is "What do I want from my investing?" My observation is that most people say money but don't realize that they want excitement. The importance of this observation cannot be exaggerated. A thorough self-exploration and interrogation needs to happen before an investment strategy can be created. After all how can we create a strategy if we are not clear on our goals? By the way, if excitement is really the answer, money will be lost; if money is the answer, mental health and (probably) money will be lost. The right answer is a passionate interest and curiosity in the process of investing. Anything done purely for financial gain is rarely done well and often leads to a sense of unhappy dislocation.

If excitement is really the desire, there are probably better, healthier, cheaper alternatives to the stock market. Let's leave you here if that is your desire!

For those legitimately interested in the process of investing…READ ON

We have established my opinion that an investment strategy is critical to success…is this really that hard to believe? Most of us do something death defying every day. We get in a coffin with wheels that has excessive power and is not particularly forgiving when a mistake is made…the road toll is testament to that. How is it that most of us do this dangerous thing everyday and live to tell the tale? The answer of course is we have a strategy! We have a mechanically sound tool (car), we know how to drive it, and we then adhere to the road rules and have faith that others will do the same. This simple strategy keeps us safe most of the time but we can see that if we deviate from these rules by drink driving or breaking the road rules we often end up failing to achieve our goals with disastrous consequences.

It is critical when doing something dangerous to have a set of rules that work and **stick to them**. The more dangerous the activity, the more rules are required, so investing should have quite a few given you are risking precious capital and we seem to find many ways to lose it.

Below is an initial set of rules that I believe every budding investor should adhere to. These are principle style rules that apply regardless of the market you operate in or the strategy employed.

RULE 1

Have an investment strategy *that over time has proved successful and is consistent with your personal variables such as temperament, time, goals etc. Note: Goals must be realistic.*

In regards to the investment strategies of professionals from the greats like Warrenn Buffett to *marginally* less successful full-timers like me ☺ there are two observations I will make: Firstly every investment strategy is different and secondly: There are underlying principles that are consistent between differing strategies…more on that latter.

Rule 2

Stick to your rules! You can change the rules or strategy (post appropriate research) but you can't break the rules!

A sound strategy will help you to not break rule number 3.

RULE 3

Don't lose money.

Warren Buffett once said "*Rule number 1 don't lose money, rule number 2…don't forget rule number 1"*

This is not as flippant as it sounds. While sometimes losing money is part of investing, a sound strategy minimizes the chances of losses and the size of actual losses. Loss minimization is a critical component of any investing or trading activity.

This must be a primary focus of investing. Rene Rivkin used to say if you minimise losses, the profits tend to take care of themselves.

Rule 4

Continuing on from the previous rule:

Consider the downside risk first and only move to consider the upside if the downside risk is tolerable. As an example: a potential 30% profit may seem attractive initially but not in the case that there is 100% risk with a high probability of failure.

The rules above provide a simple starting point for budding investors. I see no reason to break any of them ever!

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