

PLAN A.

A GUIDE FOR MANAGING RISK UNDER NORMAL MARKET CONDITIONS

Important points to keep in mind

The benefit of having a well-designed Plan A is that it takes much of the guesswork out of making investment decisions. Without a clearly defined game plan, investors are constantly reacting to the often violent swings in the market, and in the value of their invested savings.

This gut-level, reactionary decision making leads to errors in judgement, inconsistent performance, and frustration. Emotions cause mistakes, and a well-designed Plan A will help keep you focused on what needs to be done and what should be avoided.

Financial Illiteracy

One of the most surprising things we find throughout our society is the low level of financial literacy. It's independent of education, intelligence, and experience. For example, doctors, lawyers, and corporate executives are incredibly competent in their chosen field, but when it comes to investing, they make the same mistakes that all of us make. And they experience the same negative emotions of frustration, regret, embarrassment, and guilt. The net effect is often "decision paralysis."

It all starts with a clearly articulated investment philosophy

Every Plan A begins with an investment philosophy. This is a brief synopsis of your beliefs and assumptions about how investing works, and how you plan to approach the task of investing.

Your philosophy is your guiding principle, your North Star, and your unifying set of beliefs. Your philosophy will inform everything else you put into your plan – your strategy, your tactical plan, your list of approved asset classes, your trading checklists – everything.

As you move through the steps of designing your Plan A, everything you do must comply with your investment philosophy.

Here are some examples of investment philosophies:

"Investing in the market is way too complicated, and I don't have the time or interest in learning how to master it on my own. So, I will seek outside counsel to design my plan."

"I don't think it's practical for me to try to beat the market. Therefore, I will try to build a plan that will match the market return, using low cost index funds, and only rebalance once per year."

"I have the time and interest to try to beat the market averages. Therefore, I will build a plan that is more aggressive than most. I can handle the ups and downs of the market, as long as I beat the market over the long term."

"The market goes up about 10% per year, so the best way to approach investing is to stay in the market and ride out the ups and downs."

"The one thing I will not tolerate is a large decline in the value of my portfolio. Therefore, I will structure my plan in a way that gets me out of the market before a big decline is coming, and get me back in when the all-clear is sounded."

"It shouldn't be that hard to find great companies to invest in, so I will focus on doing my own research and picking stocks that I think will double or triple within a few years."

"I will focus on beaten-down and out-of-favor stocks that have the potential to recover and pay off ten-fold over time."

"Stocks that pay the highest dividends are the way to go. I will build a portfolio of stocks that are paying at least 7% per year in dividends, and never sell them."

Choosing a strategy

There are many strategies to choose from. There is no such thing as the perfect strategy that will work for every investor, although the financial advice industry may try to sell you on their perfect strategy.

Your strategy, or strategies, are the specific approaches you will take to meet your investment goals. If your goal is to beat the market, your strategy must include stocks that have the potential to grow faster than average.

If your goal is to match the market, your strategy will be to buy low cost index funds and let the market do its' thing.

If your goal is to generate a specific amount of annual income, your strategy will focus on high-paying stocks, bonds, REITs, MLPs, etc.

Tactical steps

Once you have decided on your strategy or strategies, the next step is to lay out the specific steps you will take to achieve the goals that are assigned to the strategy. For example, let's say that your strategy is to generate annual income of 7%. The tactical steps will include things like where you will get your information, what parameters you will use in your screening process, and what types of securities or asset classes you will avoid.

If your philosophy is to beat the market, and your strategy is to identify the next Microsoft or Apple or Google, then your tactics will encompass the specific characteristics you will look for in a company that will qualify it as a viable candidate for inclusion in your portfolio.

The architecture.

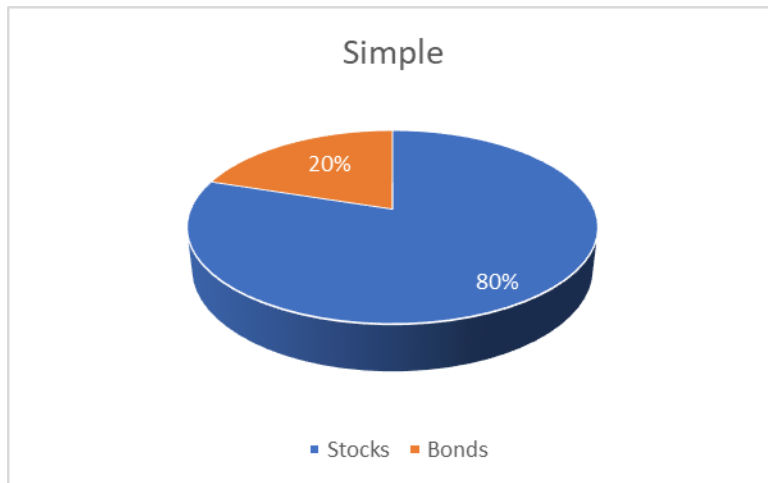
The architecture of a robust Plan A is your asset allocation matrix. This is the critical step that gets so many investors into trouble. When you are investing by the seat of your pants, there is no balance between asset classes in your portfolio.

Having a defined architecture will go a long way to keeping you on track and helping you avoid decision mistakes. Here are some examples of asset allocation architectures, starting from the simplest to the very complex.

Simple: 2 Assets

Stocks 80%

Bonds 20%

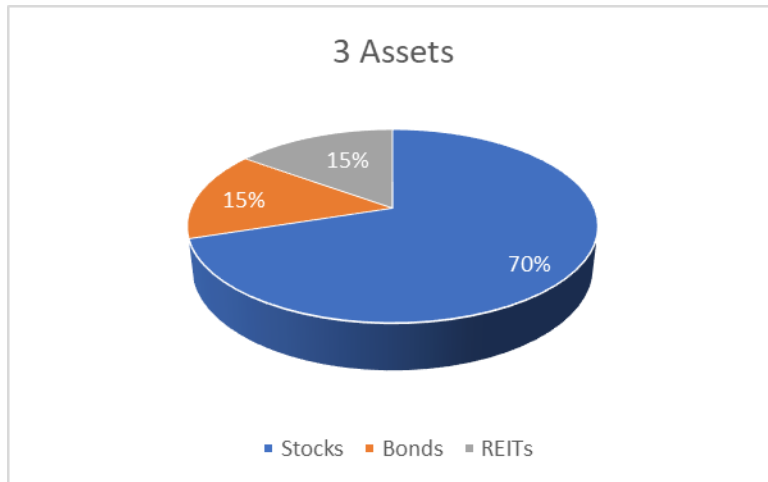


Simple plus REITs: 3 Assets

Stocks 70%

Bonds 15%

REITs 15%



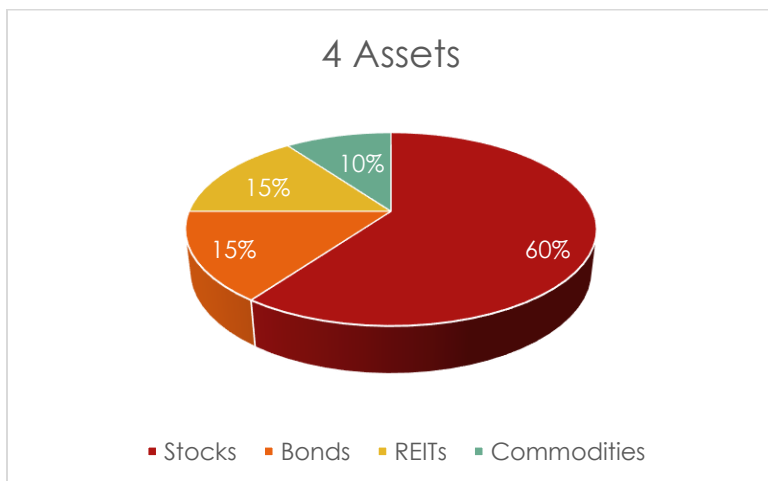
Simple-enhanced: 4 Assets

Stocks 60%

Bonds 15%

REITs 15%

Commodities 10%



Simple-extended: 5 Assets

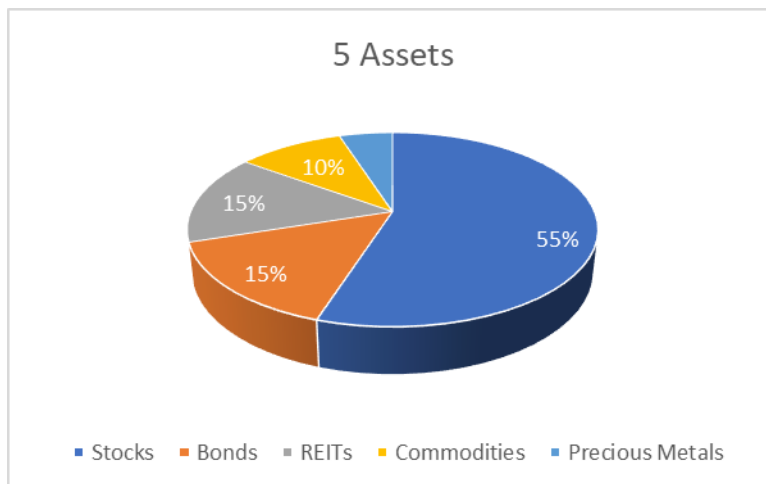
Stocks 55%

Bonds 15%

REITs 15%

Commodities 10%

Precious Metals 5%



Moderately Complex: 6 Assets

Stocks 55%

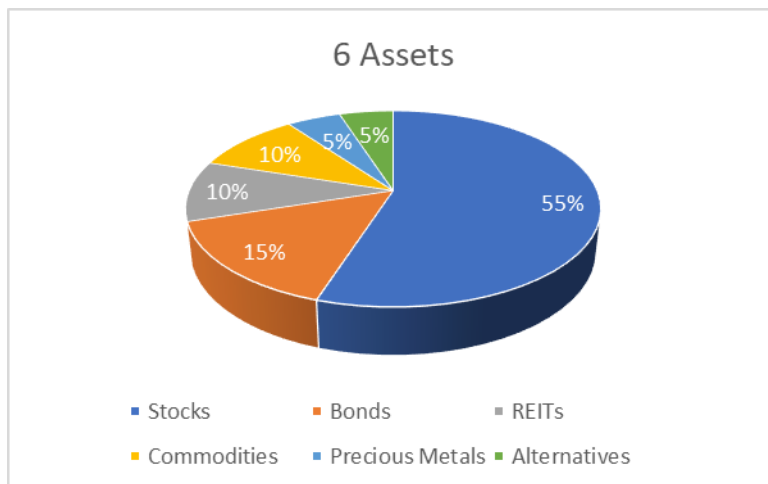
Bonds 15%

REITs 10%

Commodities 10%

Precious Metals 5%

Alternatives 5%



Conclusions

The numbers in the above charts are just a starting point. You can (and probably should) change any of the percentages to more accurately reflect how aggressive you want to be with your Plan A.

The goal of this article was to get you familiar with the process of designing a robust Plan A. The details will change for each investor, but the framework will be the same.

Not included in this article are a few important features that I will cover in a follow-up piece. One of these features is the Checklist. Some investors need to get into more detailed steps when working on their Tactical plans. Checklists take this farther by defining specific steps to take in order to stay focused and on track with the plan.

Another feature is the Maintenance section. Once your plan is designed and implemented, investors need clear instructions about maintaining the balance of their portfolios. Should you rebalance once per year? Once per Quarter? Never?

One last thing. Your Plan A is a living document. It's not static. As you develop more awareness and better skills as an investor, you will want to adapt your plan to reflect this. But it's very important to keep in mind that the way to adjust your decision making is not to abandon your plan and start shooting from the hip. The best thing to do is go back and review your plan and make the changes you think are necessary to keep up with your rising skill level.