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Alchemy 101

There hasn't been a wedding or a New Year's Eve party that I have gone to in the past 20 years where I haven't been cornered into a conversation by somebody who was looking for the Holy Grail of how to make more money in the financial markets. It seems that the desire to turn lead into gold didn't fade away with the alchemy of the Middle Ages. There persists the notion that some universal investing elixir exists that can create value where there is none. After all, we can map the entire human genome, so making money in the markets should be a predictable and repeatable science.

The truth is that money management is as much art as it is science. The greater truth still lies in the proverb: *"The art is not in making money, but in keeping it."* So it's not surprising that very few people have come to my office seeking the wisdom of "how not to lose money."

The irony is that there are far more ways to lose money than there are to make it. Some are obvious, like running it through the wash in your jeans pocket or betting it all on black at the roulette table. Face it, Vegas doesn't keep the lights on by paying out winners.

Others ways of losing money are insidious like inflation and taxes. Ask anyone paying the healthcare costs for an aging parent or funding the expense of a college education if they are really in a period of low inflation. Count how many different taxes you are subject to this year. I come up with 22 ranging from my auto tag to the Medicare surtax.

What I can tell you from my experience in helping people plan to meet their financial objectives is that more money is lost due to indecision than to making the wrong decision. It is not enough to comprehend the impact of inflation or taxes on your ability to achieve goals. You have to do something about it. It is the same for knowing your portfolio's exposure to downside volatility. What is the point if you aren't working a plan to reduce it or, better yet, not experience it at all?

While it is far from alchemy, there is a seemingly magical transformation of behaviors that occurs through the process of ongoing financial planning. The irrationality of fear and greed give way to clarity and confidence in decision making. The bigger picture presents itself in a manner by which we can see futility of taking excess risk, and perhaps more importantly, the consequences of not doing anything at all.

The Joy and Pain of Bubbles

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Remember how much fun it was as a child playing with bubbles. Sometimes it was fun to try and make as many as you could with one wave of the wand. The greater thrill though was in trying to see how big of a bubble you could make. The bigger it got, the more exciting, even though you knew it was going to burst. And when it did, you would be left with a soapy mess that sprayed all over you from the fallout. Still, you would try again because it was fun while it lasted. Who knows? Maybe this time you wouldn't get any on you.

Asset bubbles are fun too, while they last, but the mess that they leave behind when they burst is quite different. Investors lose confidence in markets and financial goals don't get funded. Sometimes the financial and emotional mess can take decades to clean up.

Bubbles are formed in assets when their price reaches levels far in excess of what they are actually worth. Usually, this is because of an extreme demand for the asset. It can also happen when there is too much cash in the financial system.

One of the first recorded asset bubbles in history was in the Netherlands in the 1600s. Interestingly, the asset that reached extremely high values was the tulip bulb. Excitement for these flower bulbs created such demand that their value could exceed 10 times the annual wage of the average worker. People speculated their way into great fortune before the market collapsed in May of 1637 and financially ruined a large portion of the Dutch population.

Recently we have lived through the Tech Bubble of the early 2000s and the Housing Bubble in 2007-2008. While they affected different sectors of the market, the two bubbles did have something in common – they burst right after everybody who had been sitting on the sidelines decided to jump in on this "late, great investment opportunity."

Before deciding whether or not to commit a significant portion of your investment capital to any particular market segment or asset class, take a step back and see who has already made the investment. When everybody on the street is proclaiming the investment as a no-brainer easy way to make money, you can be sure that there will be a rapid increase in prices in a short period of time and the formation of an asset bubble is underway. Sometimes the better decision is to not take part in the joy of making the bubble in order to avoid the sting of letting it burst before your eyes.

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