Discipline and Investing

When we first come to investing, we rarely give a thought to the importance of discipline. Somehow it does not appear in the picture. The nature of the problem has not yet emerged in our minds.

Instead, we imagine that the main problem is stock selection. If only we can learn how to select the best stocks, the rest will be easy. Profits will follow automatically. I have seen this dynamic in action over and over again. If I run a seminar on selecting the best stocks, the bookings are usually heavy. However, on those occasions when I speak on other topics, such as when to sell, or even worse, how to cut losses, the bookings are much lighter. Clearly most people think the problem is stock selection.

This leads many on a long search for the best method of picking stocks. They try all sorts of fundamental analysis techniques and all sorts of technical analysis techniques. Each is abandoned in turn because it makes losses. Some become so discouraged that they abandon the whole idea of investing – often after losing quite a lot of their money.

Where they have gone wrong is that they have not graduated to the idea that all investing involves losses. The way to judge any method is not whether it makes losses sometimes, but whether it makes a greater sum of profits than it makes a sum of losses. In other words, what is the net or *bottom line* result for our portfolio of stocks for each period over which the method is assessed?

This realisation that losses are unavoidable comes from the insight that all investment methods are based on some sort of probability game. If we are buyers of value, the idea is that the probabilities favour the market coming to recognise and correct the under-valuation in time. If we are buyers of momentum, the idea is that strong trends in general tend to persist for some time rather than fail. However, there is no *holy grail* in the sense that many start looking for it – that there is some magical system that only ever makes profits.

So, the name of the game becomes how to limit losses, while allowing profits to build. For those who reach this point, it soon becomes a realisation that the key is discipline. But what do we mean by this idea of discipline? How can it be defined?

John Train, in one of his books makes spells out a fundamental truth about investing: that even a mediocre method, if it is consistently applied, will beat someone who switches from method to method as they go along. The key word then, is consistency. Find a method and stick with it through thick and thin.

Will any method do? Well, no, it has to be researched and tested. However, it is my experience that there are many ways to make money in the markets. There are a great number of plans that will succeed. We just have to read the many books written by successful investors to appreciate how wide the range of successful approaches is. So, it is not that difficult to come up with a plan that will yield profits.

Then all we have to do is follow it. That is the real definition of discipline – the faultless execution of a soundly based and tested investment plan.

Now, there are two important ways in which discipline can break down:

Firstly, the investor can fail to execute the plan correctly. They may hesitate at critical points. They may ignore signals generated by the plan, based on all kinds of rationalisations. These are the investors whose discipline has failed. They usually fail to hold their discipline because they lack faith or commitment to the plan. This faith is often lacking because they have not spent enough time testing it.

Secondly, the investor may not have given up their search for the *perfect* method. No matter how well their plan is working, they still have in the back of their mind that someone else is doing better and if only they switch to that method, they too will do better. These are the investors who are still to understand that there is no perfect method and that the search for it is what is undermining their discipline.

In many respects, the first group have an easier problem to solve than the second group. If they are still hankering after the *holy grail* then the search for it will continue to destroy their discipline. I try to teach these people that they must deal with their problem in a particular way. Many of my readers are going to hear this advice over and over again from me, because this is so common a problem. It is simply this:

Do not start investing until you have written down a researched and tested plan. Then implement it. Record and evaluate you results. If you think you can improve it, close out all the investments based on it. Write down the new system and implement it. Continue this process as long as you need to. The key point is that the thing that will *poison* everything you do is changing plans in mid investment. It is fatal almost all the time. Importantly, it can never be a fair test of a method to see how an investment goes that was selected on one method and completed on another.

Now, back to the first group - those who have a plan, which they stick with, but do not execute faultlessly. Some people will always find sticking to a method easier than others. It has to do with many things that go to who we are as a complete person, including personality, attitudes, training and experience. However, there are some practical strategies that can help with developing discipline:

Firstly, we can start to keep an investing record. This can be in the form of a diary or it can be in the form of a checklist. However, it is kept, the important thing is to write down what we do for each investment. In particular, it is important to write down money management calculations. This will force us to write down our stop-loss level, which is a necessary basic input to money management calculations. The power of things that are written down is quite amazing. Once it is down on paper it is far less easy to fudge stop-losses or other signals.

Secondly, we can look for someone to act as our trading companion. Someone who we are prepared to explain our plan to and discuss each investment with as it goes along. You might think that this person has to pull us up if we depart from the plan, and this may happen sometimes. More likely though is that we will pull ourselves up. Because we have to describe to them each step we take in terms of our plan, we will actually find they do not need to bring us back on track very often. All they really need is to ask us the occasional question and we will find that we are doing the rest. Some people keep their investing diary, discussed in the previous paragraph, in the form of a letter to their imaginary investing companion, explaining each investment in terms of their plan.

Finally, look to reward yourselves when we follow our plan. Try to change the way you think about losses. All losses are not the same. There are *good* losses and *bad* losses. A bad loss is when we lose because we did not follow the rules of our plan. These we need to try to correct using one of the two strategies discussed above. However, good losses are those that come despite following our system exactly. These are normal costs of our investing business and we should actually congratulate ourselves for taking them quickly and easily.

A corollary of the third strategy is to also try to change the way we think about profits. There are also *good* profits and *bad* profits. We need to try to congratulate ourselves when we make a profit from following our plan. However, if we make a profit, despite breaking one of the rules in our plan, we should stop and consider that this is even worse than making a bad loss. And it can be far more insidious. If we are breaking our rules and making a loss, we rarely feel good about it at the time. However, if we are breaking our rules on a profitable investment, we often feel fine. We are getting away with it. However, this type of behaviour sets us up to break our rules again and again. It destroys our discipline. Sooner or later it will cost us money. We should try to never take credit publicly for making profits when we broke our rules. We should try to accept internally that we were only lucky. Luck has no part in investing. Luck is about gambling. Investing is a business. Gambling is an entertainment. Make sure you know the difference.

May the rules go with you.

To read more of my work

Previous Articles

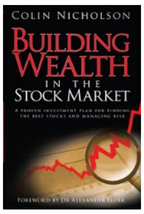
All my previous articles for the free website are now on the *Educational Articles* page on the Free Resources menu. They are now listed alphabetically by title with a brief description of their contents.

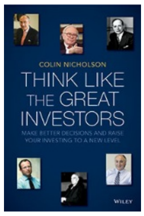
Books

I have written two books, both of which are available for purchase from the ***Buy Books*** menu:

BUILDING WEALTH IN THE STOCK MARKET – A proven investment plan for finding the best stocks and managing risk

THINK LIKE THE GREAT INVESTORS – Make better decisions and raise your investing to a new level





Members Website

Follow my thinking on my own investments, disclosure of my portfolio as I go, weekly market scans, weekly market charts and analysis plus many more articles about investing and analysis

I am one of the very few investors who publishes their investment results each year, which I have done since 2000 – see the Investment Returns page on the About Colin menu on the website