

E + R = O: A Formula for Success

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Combining an enduring investment philosophy with a simple formula that helps maintain investment discipline can increase the odds of having a positive financial experience.

AN ENDURING INVESTMENT PHILOSOPHY

Investing is a long-term endeavour. Indeed, people will spend decades pursuing their financial goals. But being an investor can be complicated, challenging, frustrating, and sometimes frightening. This is why it is important to have an investment philosophy you can stick with—one that can help you stay the course when things get rough.

This simple idea highlights an important question: how can investors maintain discipline through bull markets, bear markets, political strife, economic instability or whatever *crisis du jour* threatens their serene progress towards their investment goals?

Over their lifetimes, investors face many decisions, prompted by events that are both within and outside their control. Without an enduring philosophy to inform their choices, they can potentially suffer unnecessary anxiety, which may lead to poor decisions and outcomes that are damaging to their long-term financial well-being. When they don't get the results they want, many investors may blame things outside their control. They might point the finger at the government, central banks, markets or the economy. Unfortunately, the majority may not do the things that might be more beneficial—evaluating and reflecting on their own responses to events and taking responsibility for their decisions.

Some people suggest that among the characteristics that separate highly successful people from the rest of us is a focus on influencing outcomes by controlling one's reactions to events, rather than the events themselves. This relationship can be described in the following formula:

$$E + R = O \text{ (Event + Response = Outcome)}^1$$

Simply put, this means an outcome—either positive or negative—is the result of how you respond to an event, not just the result of the event itself. Of course, events are important and influence outcomes, but not exclusively. If this were the case, everyone would have the same outcome regardless of their response. Let's think about this concept in a hypothetical investment context. Say a major shock, such as the failure of a bank, causes a market to fall (event). In a panicked response, potentially fuelled by gloomy media speculation of the resulting uncertainty, an investor sells some, or all, of their investment (response). Lacking a long-term perspective and reacting to the short-term news, our investor misses out on the subsequent market recovery and suffers

anxiety about when, or if, to get back in, leading to suboptimal investment returns (outcome).

To see the same hypothetical example from a different perspective, a surprise event causes markets to fall suddenly (E). Based on his or her understanding of the long-term nature of returns and the short-term nature of volatility spikes around news events, an investor is able to control his or her emotions (R) and maintain investment discipline, leading to a higher chance of a successful long-term outcome (O).

This example reveals why having an investment philosophy is so important. By understanding how markets work and maintaining a long-term perspective on past events, investors can focus on ensuring that their responses to events are consistent with their long-term plan.

THE FOUNDATION OF AN ENDURING PHILOSOPHY

An enduring investment philosophy is built on solid principles backed by decades of empirical academic evidence. Examples of such principles might be: trusting that prices are set to provide a fair expected return; recognising the difference between investing and speculating; relying on the power of diversification to manage risk and increase the reliability of outcomes; and benchmarking your progress against your own realistic long-term investment goals.

Combined, these principles might help us react better to market events, even when those events are globally significant or when, as some might suggest, a paradigm shift has occurred, leading to claims that “it’s different this time.” Adhering to these principles can also help investors resist the siren calls of new investment fads or, worse, outright scams.

THE GUIDING HAND OF A TRUSTED ADVISER

Without education and training—sometimes gained from bitter experience—it is hard for non-investment professionals to develop a cogent investment philosophy. And, as we have observed, even the most self-aware find it hard to manage their own responses to events. This is precisely why a financial adviser can be so valuable—by providing the foundation of an investment philosophy and acting as an experienced counsellor when responding to events.

We know that investing will always be both alluring and, at times, scary, but a view of how to approach investing combined with the guidance of a professional adviser can help people stay the course through challenging times. Advisers can provide an objective view and help investors separate emotions from investment decisions. Moreover, great advisers can educate, communicate, set realistic financial goals and help their clients deal with their responses even to the most extreme market events.

In the spirit of the $E + R = O$ formula, good advice, driven by a sound philosophy, can help increase the probability of having a successful financial outcome.

1. Jack Canfield, *The Success Principles: How to Get from Where You Are to Where You Want to Be* (New York: HarperCollins Publishers, 2004).

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