THOUGHTS FOR THE WEEK

WHAT GAME ARE YOU PLAYING?

April 8, 2022

The first thing you should understand as an investor is what game you're playing. Financial markets, maybe only second to biology, are massive, complex dynamic systems with significant reflexive properties. Wow, that's a mouthful. Translation: Markets are comprised of trillions of inputs, all dynamically interacting with each other, and one input can influence the course of another – which is reflexive.

We've used this analogy before to describe the reflexivity present in markets – it's akin to a road changing shape depending on how your tires are moving across it. The proverbial "butterfly flapping its wings in Thailand…" There are no fixed variables – all variables are dynamic and constantly shifting.

Within this dynamic playing field, there are countless games at play. However, there are two games that dominate – each with untold number of derivative games underneath: Trading and Investing. Neither is a superior game – both offer the opportunity for success or failure. But as a market participant, it's imperative to understand which game <u>you're</u> playing, and to not mistake one game for the other. There's a saying, "Wall Street is an expensive place to get an education" – and we think much of that "cost" is borne by participants unsure of, or downright confused about, which game they are playing in financial markets.

NYU Professor Aswath Damodaran (we refer to him as "AD") has written about the differences between the two games – trading and investing (link to one post here, AD - Trading v Investing). In his inimitable style (AD is simply one of the best teacher's we've encountered), he contrasts trading and investing:

Trading is determined by supply and demand, uses tools such as comparable multiples and charting, and includes drivers such as market moods and narratives.

Investing is determined by the fundamentals of a business, uses tools such as discounted cash flow analysis (DCF) and excess return models, and includes drivers such as cash flow from existing assets and growth and quality of cash flows.

Again, neither approach is right or wrong. And many diversified investment portfolios have a mix of both "games" going. For example, an investment portfolio might include "investing" strategies such as equity index investments or a private equity fund, and also employ a few "trading" strategies, such as a global macro hedge fund or arbitrage fund. The diversification of thought and style can be beneficial as there are market periods when the environment may seem to favor one "game" over another – although neither we nor anyone that we know of has developed a reliable and repeatable method for identifying *when* those environment shifts are *about* to occur.

The biggest risk instead lies in misunderstanding *what game you're playing* in financial markets. It's all too easy to mistake trading for investing, or to make a major strategy change based on a view of "what game will work in this environment". For example, a strategy purported to be playing the investing game may worry about a potential "earnings miss" pressuring a stock price, and decide to sell that stock, even if the long-term prospects for the company are bright. A subtle shift, but one that turns a long-term strategy predicated on tax efficient compounding into a short-term, trading type strategy that then requires a series of correct near-term decisions rather than one long-term decision.

In our view, it is nearly impossible to consistently flip between the trading and investing games and achieve acceptable outcomes. It can appear an enticing proposition – particularly when the press labels a current period a "trader's market" or a "stock picker's market". But the more likely outcome is that the investor will get caught trying to chase the crowd, or worse, get involved in a game for which they don't have the skill set and become one of the "weak hands at the table."

We're not dogmatic, we'll make changes if needed. But our experience is that sticking with a consistent strategy – playing the same game, rather than constantly joining a new one – improves the odds for a satisfactory outcome. We favor the "investing" game – it's what we know, where we think we have an advantage, it tends to be tax efficient, and it tends to work over time. We also know there will be times when that game will be out of favor – and we're prepared to accept that. Because the alternative – trying to switch between games based on our perception of the current environment – increases the odds of a failure. And that gets back to the idea of an "expensive Wall Street education." A bill we'd rather avoid.

Mike, Cate, Scott, Marina, Oscar, Suzy, and Willis

Private Wealth Advisors
Mike Burbank, Managing Director Wealth Management
Scott Hafeli, CFA, Executive Director
Willis Davis, CFA, First Vice President
Morgan Stanley Private Wealth Management
555 California Street, 14th Floor | San Francisco, CA 94104
Office: 415 576 3131

Morgan Stanley Smith Barney LLC ("Morgan Stanley"), its affiliates and Morgan Stanley Financial Advisors or Private Wealth Advisors do not provide tax or legal advice. Clients should consult their tax advisor for matters involving taxation and tax planning and their attorney for matters involving trust and estate planning and other legal matters.

Asset allocation, diversification and rebalancing do not assure a profit or protect against loss. There may be a potential tax implication with a rebalancing strategy. Please consult your tax advisor before implementing such a strategy.

The views expressed herein are those of the author and do not necessarily reflect the views of Morgan Stanley Wealth Management or its affiliates. All opinions are subject to change without notice. Neither the information provided, nor any opinion expressed constitutes a solicitation for the purchase or sale of any security. Past performance is no guarantee of future results.

This material does not provide individually tailored investment advice. It has been prepared without regard to the individual financial circumstances and objectives of persons who receive it. The strategies and/or investments discussed in this material may not be appropriate for all investors. Morgan Stanley Wealth Management recommends that investors independently evaluate particular investments and strategies and encourages investors to seek the advice of a Financial Advisor. The appropriateness of a particular investment or strategy will depend on an investor's individual circumstances and objectives.

Any type of continuous or periodic investment plan does not assure a profit and does not protect against loss in declining markets. Since such a plan involves continuous investment in securities regardless of fluctuating price levels of such securities, the investor should consider his financial ability to continue his purchases through periods of low-price levels.

S&P 500 Index is an unmanaged, market value-weighted index of 500 stocks generally representative of the broad stock market. An investment cannot be made directly in a market index.

Bonds rated below investment grade may have speculative characteristics and present significant risks beyond those of other securities, including greater credit risk and price volatility in the secondary market. Investors should be careful to consider these risks alongside their individual circumstances, objectives, and risk tolerance before investing in high-yield bonds. High yield bonds should comprise only a limited portion of a balanced portfolio.

Bonds are subject to interest rate risk. When interest rates rise, bond prices fall; generally, the longer a bond's maturity, the more sensitive it is to this risk. Bonds may also be subject to call risk, which is the risk that the issuer will redeem the debt at its option, fully or partially, before the scheduled maturity date. The market value of debt instruments may fluctuate, and proceeds from sales prior to maturity may be more or less than the amount originally invested or the maturity value due to changes in market conditions or changes in the credit quality of the issuer.

Bonds are subject to the credit risk of the issuer. This is the risk that the issuer might be unable to make interest and/or principal payments on a timely basis. Bonds are also subject to reinvestment risk, which is the risk that principal and/or interest payments from a given investment may be reinvested at a lower interest rate.

Morgan Stanley Private Wealth Management, a division of Morgan Stanley Smith Barney LLC. Member SIPC.

CRC 4662404 dtd 04/08/2022