

THOUGHTS FOR THE WEEK

TRADE-OFFS

July 22, 2022

All decisions come down to trade-offs. You're giving up one thing, call this option A, in hopes of gaining something better, call this option B. And the expected value of B outweighs what you're giving up with A – which is why you chose B. This is true whether considering an investment change, or whether to let your child play video games while you're working from home. You can't escape trade-offs – few decisions are costless, at least the impactful ones. But understanding trade-offs helps clarify the decision-making process.

You are no doubt aware of trade-offs in the decision-making process. Business school education is filled with how to build a decision tree – a multi-branch form of examining trade-offs. Governments (and all other entities) make decisions incorporating cost / benefit analysis. NBA coaches use trade-off analysis when juggling in-game line-up... “If I (Steve Kerr) pull Steph and rest him now, I'll lose scoring power for the next 5 minutes but have a fresher Steph in the 4th quarter.”

In the work we do for clients, two decisions with significant trade-offs frequently occur: 1) Should my investment plan be altered if I'm worried about losses? 2) How much can I spend per year, over my lifetime, and not run out of money? We'll examine both.

Start with, “Should I alter my investment plan?” First, there are no right or wrong answers. A person with a 50-year investing time horizon and little cash needs presumably doesn't care if the stock market declines, say, (30%). But the person dependent on a portfolio for steady income, and with a shorter investing time horizon, may deeply care. That person may not have adequate time to wait for a recovery. Or may be forced to reduce lifestyle spending. Nonetheless, the decision that investor is faced with carries considerable trade-offs.

Charlie Munger, Warren Buffett's sidekick, has said, “...you want to avoid interrupting the compounding process”. The “process” is simply the gyrations in price a long-term investor lives with to hopefully earn acceptable long-term returns. Prices don't move in a linear fashion, they hop. Miss a few of those hops to the upside, and you may impair your long-term returns. So, we prefer to not interrupt the process, and to control risk through adequate liquidity levels – both near and long-term.

Back to the investor in our example, who has a shorter investing horizon and worries about losses. Raising more cash and / or making the portfolio more conservative will help protect value but may reduce future earnings power. We don't think one can move in / out of long-term investments with consistent success, so the decision, in our view, has long-term effects. Particularly if the investor requires a certain level of long-term returns to make the “spending model work”. Reducing earnings power reduces your chance of hitting your return bogey. But not preserving capital has a cost too – particularly if prices decline and stay there for a long period of time. Again, no right answers. The investor is faced with a series of consequential trade-offs and must decide what carries more value – increased certainty but lower potential vs. decreased certainty but higher potential.

Next let's examine the "how much can I spend" trade-off. Investors can't control what markets do. They can't control the direction of interest rates. Or the whims of the Fed. But they can control costs and taxes, and the biggest element of control is how much an investor spends from a portfolio.

A rule of thumb is that a 3-4% withdrawal rate is sustainable, meaning if your investments are valued at \$10M you can spend \$300-\$400K / year and likely not run out of money (that's a rule of thumb, not a law of nature). But that spend rate carries significant trade-offs. The higher the rate, the lower the margin of safety for the future. Spend more now and an investor "needs" a higher future return that may not be available. The odds of a drastic future lifestyle cut increase the more one spends.

But it's also possible to be too conservative, to make un-necessary lifestyle sacrifices in pursuit of sustainability. For some this might be fine, they might be happy living well below their means. For others this may cause a nagging sense of missed opportunity and regret. You only get one journey, and foregoing experiences to "save" money may not provide the best "value" in your life. As they say, "If you don't fly Business Class your kids will". Once again, no right / wrong answers. Just trade-offs.

One of our key roles is identifying and debating trade-offs with clients. We can run sophisticated models to help gauge odds. We can lean on decades of pattern matching skills. We cannot however predict the future. But we can use those tools and skills to illuminate choices. To help bring clarity to your decision-making process. And then sit in the background and operate within the parameters of your decisions. And hopefully that gives you the ability to go out and do the things you love.

Mike, Cate, Scott, 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

If you would like to unsubscribe to this email, please contact Oscar Castillo at Oscar.Castillo@morganstanleypwm.com

Please note that the URL(s) or hyperlink(s) in this material is not to a Morgan Stanley Smith Barney LLC website. It was created, operated, and maintained by a different entity. Morgan Stanley Smith Barney LLC is not implying an affiliation, sponsorship, endorsement with/of the third party or that any monitoring is being done by Morgan Stanley of any information contained within the linked site; nor do we guarantee its accuracy or completeness. Morgan Stanley is not responsible for the information contained on the third-party web site or the use of or inability to use such site.

The information and data contained in this piece are from sources considered reliable, but their accuracy and completeness are not guaranteed.

This illustration in this piece is hypothetical and shown for illustrative purposes only. The illustration is not intended to predict the returns of any particular investment, which will fluctuate with market conditions. Actual results may differ from those depicted in the illustration. The Burbank Hafeli Group at Morgan Stanley Private Wealth Management is focused on serving the investment and financial planning needs of the founders of food, beverage, and consumer products companies and private equity and investment banking professionals.

Mike Burbank was recognized as one of the Top 400 Advisors in the United States by the Financial Times in 2013 and 2014. Scott was also recognized as one of the Top 400 Advisors in the United States by the Financial Times in 2015.

<http://www.morganstanley.com/disclosures/awards-disclosure.html>

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 4860973 dtd 07/22/2022