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 <u>not interrupt the process</u>, 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 <u>requires</u> 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.

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CRC 4860973 dtd 07/22/2022