

This letter is dated October 2021

Geared Up and Ready to Roll

My sons set up a mountain biking adventure during our summer vacation in Wyoming and I decided to join them. I had no idea what I was getting into. I was like so many investors these days, jumping into something that sounds good with little due diligence and not enough respect for the risk involved. I got a crash course, if you will, in mountain biking. The ride up was easy; it was the ride down that gave me trouble. In mountain biking it's how you handle the declines that matters most. I think the same is true with investing.

The first thing I noticed when we met up with our guide was that she was wearing padded clothing and had a motorcycle-style helmet. We were in t-shirts and shorts with regular bicycle helmets. When we asked if we should suit up in the same gear she was wearing, our young guide said no, that she was only wearing it because her company required her to. We took her advice; she was the professional and we were first-timers, eager to get going. Besides, it was hot and all that protective gear looked uncomfortable.

We followed her toward the mountain, listening as she told us how to put our bikes on the ski lift. Whoa, I thought, we need to take a ski lift? That surprised me, that's how little I knew about what I was about to do. As we approached the lift, I noticed the other bikers were all young and wearing even more pads than our guide. They looked like hockey players. I got a bad feeling in the pit of my stomach. The next thing I knew we were riding up on the ski lift, going much higher than I ever expected.

It was cool and windy at the top of the mountain trail. Our guide gave us a few instructions. First, she said to put the bike seat all the way down: "You won't be sitting." That was another surprise. Next, she told us to keep the pedals parallel to the ground except when leaning into turns. She went on to explain that the turns were banked and we should enter high on the bank and lean down into the turn. I understood what she was saying but couldn't imagine myself actually doing it.

She looked at me and said “follow me and watch what I do,” then looked at my sons and said “you guys follow your dad.” Then off she went, over the edge. Full of anxiety I slowly crept over the edge and headed down with a death grip on my brakes. I was going too slow to enter the first turn high on the bank so I went low and tight. It was rocky but I managed to make it. I glanced up but didn’t see our guide, I only saw a steep decline into another banked turn. At that point I knew I needed more speed to ride high on the bank. I released my grip on the brakes and suddenly the pull of gravity had me flying, headed straight down into the next turn. As I closed in on it, I saw that at my entry angle, low to high, I was going to ramp up the bank and launch into the trees below. I panicked and gripped the brakes so hard that for a second it felt like I was going to fly over the handlebars. Terrified, I let off the brakes and lurched away from the rim. Luckily that worked, my momentum shifted back onto the trail and gravity pulled me down through the turn. Seeing my near disaster from behind, one of my sons shouted, “Dad, go as slow as you need to go!” That sounded like good advice to me and I kept a tight grip on the brakes for the rest of the long, steep trip down the mountain.

When I finally reached the bottom, I quit. Exhausted and stressed out, there was no way I was going to get back on that ski lift. I felt lucky that I hadn’t gotten hurt. Now that I knew what mountain biking in Jackson Hole involved, I was out. The guide asked “are you sure?” and my sons, witnesses to my troubles on the way down, answered for me: “Yes, he’s sure.” They headed for the ski lift to take another trip down the mountain.

I sat at the base and waited, watching the young bikers in their protective gear coming off the mountain and eagerly making their way back to the ski lift for another ride. They had that wonderful sense of confidence that comes from experience and proper preparation. They were loving life as I sat there feeling old and lame, worrying about my sons’ safety.

If you are going to do something risky, you better know what you are getting into and what is required to do it well. Investing, like mountain biking, involves real risks and the unprepared can get hurt. In order to be successful, you need to understand what is required and have the confidence to execute under pressure.

Rising markets can entice investors, especially the inexperienced, into taking on more risk than they can handle. It's tempting to get more aggressive, thinking that you can always make defensive adjustments later, before the market turns. The problem is that markets can fall without warning. Experienced mountain bikers wear protective gear not because they are predicting or even expecting a crash, they wear it because experience has taught them that crashes happen. They come with the territory. For investors, maintaining financial strength is like wearing protective gear. When you have the financial capacity to be a buyer, market corrections hurt less and can provide opportunities to capitalize on. Those who are overleveraged-- or just overinvested-- run the risk of having to sell into falling markets, which can result in serious financial injury.

In investing, as with most things in life, people are the most important factor. When I realized that our guide gave us poor advice on safety gear, I lost confidence in her and my anxiety went through the roof. In endeavors that involve risk, trust and confidence are essential. The founder of Bitcoin set out to create a "trustless" system. I do not believe that is possible. In my view, trust is a necessary part of every transaction. Further, I think trust in the people involved is the foundation of any investment decision. Shareholders rely on management to protect and grow the companies they own. A close look at management's compensation, equity ownership, and capital allocation decisions is a must when deciding whether or not to trust a management team.

Successful mountain bikers know how to work with gravity as they roll down the mountain. In investing, the power of compounding is the force that must be harnessed. In today's world of low interest rates and high stock prices, opportunities to compound at attractive rates are scarce. Some of the hottest companies in the market today are relying on investors to fund losses. History is full of companies launched with exciting ideas that failed. When you own assets that generate cash, time is on your side. When management reinvests it well, the power of compounding accelerates your progress.

I think that many investors will be surprised by the challenges that come with the next market decline. The stock market environment reminds me of the late 1990s, when young speculators were so eager to make their fortune they did not bother with even basic due diligence. It did not end well for them. There is a reason why those with experience wear all that uncomfortable safety gear.

It seems each generation has to develop respect for risk through their own stumbles, their own experiences. This “old-timer” has invested through many declines, starting with the crash of 1987 as a young intern. In my experience, when you have confidence that management is looking out for you, when your assets are generating cash, and when you have the capacity to buy, market declines are nothing to be afraid of. For well-prepared investors, they can offer wonderful opportunities. The ride up is so much more enjoyable when you know you can handle the next trip down. It’s good to be geared up and ready to roll.

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