

The Importance Of Having An Investment Discipline

In investing, it's necessary to have a system. Even if you're a buy-and-hold investor, that's a system. In fact, buy-and-hold investors have to do a little more than buy and hold – they have to rebalance their portfolios periodically. That involves a decision about whether to rebalance quarterly, semi-annually, or annually. And once you've made that decision, you have to follow through and do it. You can't say, "Gee, the market is running so hard; I don't want to take some money off the table now." Or, "This decline is so painful; I can't bear to throw more money at stocks now." But you won't be successful if you don't stick to the discipline you established.

Other investors, who want to be more tactical or "enterprising" as Benjamin Graham called them, should have rules too. It can be overwhelming to try to apply valuation metrics and momentum metrics to asset classes, sectors, currencies – anything that moves – every single day, and to decide which metric to emphasize and which to jettison. I've seen more smart people mismanage money because they couldn't boil down their intelligence into a system, or, once they did, follow it. Investing isn't about intelligence as much as it's about controlling your emotions.

Let's say you follow momentum in the stock market. You might apply the 200-day moving average to tell you if the market is in an uptrend or a downtrend. Michael Batnick wrote an [excellent post](#) about this recently where he showed how a simple system or backtest using the 200-day moving average could beat the market with lower volatility – at least since 1997. But simple to understand doesn't mean simple to execute for a variety of reasons. As he notes, there have been plenty of times since 1997 when simply owning stocks when they were above the 200-day moving average and exchanging them for bonds when they were below would have tested your patience. He asks rhetorically if someone would have been able to follow all the 160 signals the indicator produced over the 20-year period, if someone would have been able to take the 10 signals it delivered in 30 trading sessions, and, finally, if someone would have been able to stick with it when it was badly underperforming the S&P 500 Index.

Not following that simple rule – owning stocks above the 200-day moving average and exchange them for bonds below -- wouldn't have been the result of a lack of intelligence. It would have been the result of not being disciplined enough or not believing in the indicator when it was failing – or, more likely, convincing yourself that there's another indicator you should be following just this one time because yours was failing. St. Augustine was noted for praying, "Lord, make me chaste, but not yet." That's the way many investors wind up operating. "I'll follow my model or indicator, but not yet. Something else looks more attractive or like it's working right now; so I'm going to go with that."

Another problem besides multiple indicators that can distract you or seduce you away from the main one, is applying your indicator to many different things. Are you doing something like Batnick's simple example of a moving average to the S&P 500 and bonds? Or are you applying the indicator to foreign stocks too? And what about emerging markets stocks. And how about different sectors and industries of the stock market and different areas of the bond market like corporates, Treasuries, mortgages, high yield, and emerging markets? And are you trying to build a portfolio from many asset classes to which you're applying one or multiple indicators? Things can

get complicated and dizzying in a hurry.

Any system you set up will disappoint you at times. No system exists that's 100% foolproof. The trick is if you can keep using the system when it disappoints so that you'll still be using it when it starts working again. This isn't about how smart you are; it's about how emotionally intelligent and focused you are.