How To Become An Investing Adult

[Editor's Note: This post was originally published as one of my monthly columns in [MDMagazine](#) and is entitled "[How To Become An Investing Adult](#)."]

Today I'm borrowing heavily from ideas found in Bernstein's [Deep Risk](#) book. William Bernstein, MD, recently came out with a series of short booklets he calls *[Investing for Adults](#)*. While it might sound pretentious, the truth is that the vast majority of investors never actually reach "adulthood" as defined by Bernstein. The analogy is easily explained.

My children worry and complain about many things that don't bother me in the least. They have a short-term perspective caused by their lack of experience in life. They lack patience and their behavior is often motivated by their emotions, such as [fear and greed](#). Their ability to use logic is limited, and, at times, apparently non-existent. They have little knowledge, understanding, or appreciation for history.

As an adult, I have learned patience, sometimes in the school of hard knocks, and am better able to guide my decisions using logic and the guideposts of history.

Children Go to School for a Reason

There is a certain amount of financial knowledge that must be mastered in order to grow from an "investing child" into an "investing adult." This includes basic mathematical concepts such as compound interest and the future value of money.

It also includes understanding the basics of the tax code, retirement accounts and financial products such as stocks, bonds, mutual funds and insurance products. It also includes understanding the importance of minimizing investment expenses, avoiding active management risks and diversifying a portfolio broadly.

Investing "Children" Worry About the Wrong Risks

The biggest problem with being a child when it comes to investing is that you spend all your time worrying about the wrong risks.

In order to more easily study financial history and investing in the pre-computing age, academics were forced to use simplified models that generally equated investment risk with volatility. The problem with doing this is that, in the words of Bernstein, volatility is a "shallow" risk. It is not a risk that investing adults worry about.

Just like adults don't care what the other people on the bus think about their shoes, they also don't care that their long-term investments can be very volatile in the short term.

How Adults Deal with Personal Risks: Death, Disability, Illness and Other Liability

There are essentially three categories of risk that investing adults deal with. The first is best described as personal risks. This includes dying, becoming disabled, acquiring an illness or injury that is expensive to treat, or becoming legally liable for physical or financial damage to another person.

Investing adults don't spend a lot of time worrying about these risks because they are easily dealt with by purchasing appropriate life, disability, health, malpractice and personal liability insurance policies.

How Adults Deal With Shallow Risks: Asset Loss

The second category of risk adults deal with is shallow risk, which most investors think about when they reflect on the stock market. This is the risk that comes from the fact that the prices of assets, such as stocks, bonds, or real estate, can fall precipitously causing a very real loss of hard-earned savings.

Shallow risk may cause an investing adult some heartburn or even a few sleepless nights, but it shouldn't cause any serious financial damage. The reason why is that shallow risk is a temporary risk. The real risk here is that an investor will buy high and sell low in response to a market downturn. If the investor has sufficient discipline and liquidity to ride it out, he'll be okay in the end. This is easily demonstrated by looking at history. Even in the Great Depression or the recent global financial crisis disciplined investors who stayed the course were rewarded in the end.

An investing adult protects himself against shallow risk quite easily. First, he develops the discipline to stay the course and an understanding of his risk tolerance by "practicing" during the downturns that show up while he is young and his portfolio is small. Second, he diversifies his portfolio widely. Even if a few companies go bankrupt or a few companies or governments default on their bonds, the investor won't feel a significant loss.

Third, he has a long-term written investing plan that takes into account the fact that market downturns will take place during his years as an investor. Like the wise teenager who decides he isn't going to do drugs before he is ever tempted by the offer, an investing adult decides what he will do in a market downturn long before he is ever faced with the event. The investor's written investing plan also should take into account his unique risk tolerance and financial horizon. It simply doesn't matter what happens over the next three years when you don't need the money for two decades.

Fourth, the investing adult doesn't care what the other kids on the bus think of him. He knows his plan is well-designed no matter what the financial media or his co-worker at the water cooler says about current politico-economic events. Finally, an investing adult has sufficient liquidity to ride out financial downturns. He has enough money invested in safe assets to allow him to live for months or even years without a job or the money invested in the risky portion of his portfolio. For him, a market downturn is an opportunity, not a catastrophe.

How Adults Deal With the Risks That *Are* Worth Worrying About

Since investing adults have insured against personal risks, and developed their discipline and portfolio to easily deal with shallow risk, they are left with the third category of risk, "Deep Risk." These are divided by Bernstein into four categories: inflation, deflation, confiscation and devastation.

Even a superficial review of financial history demonstrates that these are the real risks that investors face, and that they have little to do with the standard deviation of the S&P 500. Inflation, such as that seen in Zimbabwe, Latin America, post-war Germany, or even the U.S. in the 1970s, is the most likely of these four risks, but also the easiest to deal with.

Inflation and Deflation

Inflation-linked bonds, equities and real estate, especially if held with a fixed-rate mortgage, hedge against this risk well. Deflation is rarer, especially since the end of the hard-money era, and the true risk is the economic stagnation that usually accompanies it. This risk can be hedged with long-term Treasuries, cash and, surprisingly, precious metals.

Confiscation

Confiscation can be best demonstrated by the loss of all privately held assets in Communist Russia, China and Cuba at the time of their revolutions. More recently, portions of bank accounts in economically-troubled Cyprus were seized. More common, though less dramatic, is a gradual or partial government seizure of assets through increased investment-related taxes, estate taxes, and even income taxes. It is expensive, and at times even illegal, to move significant assets off-shore to avoid government confiscation, but some limited hedging can be done by understanding tax laws, minimizing taxable income and acquiring “tax diversification” by using both tax-deferred and tax-exempt retirement accounts.

Devastation

Finally, military devastation is difficult to hedge against. Locating assets offshore (and ensuring your ability to get there) may work well in the event of localized military conflict, but in any type of Armageddon scenario, the health of your portfolio is likely to be of very minor concern to you.

Each of these “deep risks” has a different probability of occurrence and cost to insure against. There is no magic portfolio to protect against every risk, but an understanding of the true risks an adult investor faces can help guide you in designing and maintaining a portfolio highly likely to meet your financial goals.

Becoming an investing adult is a process, but one that you must go through, either on your own or with the assistance of a good adviser, if you wish to meet your financial goals.

What do you think? How have you dealt with investing risk? Are their other considerations for becoming an investing adult? Comment below!