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## OUTSIDE THE FLAGS

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# Which Hat Are You Wearing?

Most of us have multiple roles—as business owners, professionals, workers, consumers, citizens, students, parents and investors. So our views of the world can differ according to whatever hat we're wearing at any one time.

This complexity of people and their range of motivations, depending on their circumstances, highlight the inadequacy of cookie-cutter or automated investment solutions.

For instance, if you work for a taxi booking firm, you're naturally going to take greater-than-usual interest in technology that allows consumers to book cabs directly. That's because these new disintermediated services might affect how you make your living.

On the other hand, as a consumer you may welcome any initiative that increases competition, widens your choice and lowers prices.

As a taxpayer, you may look kindly on efforts to encourage user-pays systems in universities. But as a parent, you may be concerned about your teenage children taking on excessive debt to fund their education.

As citizens, we might champion a laissez faire approach to economic policy. But as investors, we may feel uncomfortable about certain policies and seek to express our values by placing limits on how our money is invested.

The point is everyone has the right to their own opinions and intelligent people can legitimately and respectfully disagree on many issues, including about what might happen in the world economy and about how policymakers should act.

The trick is in being clear with ourselves about which hat we are wearing when we make investment decisions and the trade-offs involved in reconciling our personal opinions with our desired investment outcomes.

For example, you may have an opinion on what central banks should do in normalizing interest rates. But do you really want to hang your decision about your portfolio allocation to longer-term bonds on your view of the interest rate outlook?

As a worker in an industry undergoing digital disruption, you may have an aversion to the technology putting you

out of a job. But as an investor, do you want to forsake earning a share of the wealth from the new forces created by this disruption?

As a resident of a suburb near the airport, you may oppose on noise grounds a government decision to build a new runway, but as an investor and a worker you might benefit from the increased productivity generated by the investment.

The point is we have many roles in life and there often can be conflicts between our personal beliefs and opinions in one area with our desires in another.

Our strong view on the economic outlook may lead us to think the market will come around to pricing assets based on that opinion. But the power of markets is such that they reflect the views of millions of people, many of whom may hold contrary views.

Keep in mind, also, that competitors in those markets include professional investors with multiple sources of information and state-of-the-art technology. And even they have trouble getting these forecasts right with any consistency.

This isn't to say we can't invest based on our personal principles. But we first have to start from the assumption that in liquid markets competition drives prices to fair value. Prices reveal information about expected returns. That leaves us to diversify around known risks according to our own preferences and goals.

In short, life is full of trade-offs. It is the same in investment. We may pursue higher expected returns, but we want to do so without sacrificing diversification or cost.

The over-riding principle is to understand what we can and can't control. We can have an opinion on government policy and we can express it through our vote, but we can't control the investment outcome. We can have an opinion on what should happen to interest rates, but we can't control what happens. So we diversify.

The role of a financial advisor is to help you understand these trade-offs and to separate opinion from fact, to balance your risk preferences with your desired wealth outcomes, and to accommodate your personal values within a diversified portfolio.

People with many hats require many different investment solutions. And that's a good thing.



*“Outside the Flags” began as a weekly web column on Dimensional Fund Advisors’ website in 2006. The articles are designed to help fee-only advisors communicate with their clients about the principles of good investment—working with markets, understanding risk and return, broadly diversifying and focusing on elements within the investor’s control—including portfolio structure, fees, taxes, and discipline. Jim’s flags metaphor has been taken up and recognized by Australia’s corporate regulator in its own investor education program.*

Diversification does not eliminate the risk of market loss. There is no guarantee investing strategies will be successful.

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