Twitter Thread by Ram Bhupatiraju

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"4 Simple Rules To Protect Your Portfolio From Yourself" h/t @EconomyApp ■■

Excellent article for the current environment (with big drawdowns in many high growth including some quality Co.'s)

My fav parts from the article in the thread below.

"The real threat to your portfolio is not volatility. It's your ability to cope with it. As a result, your portfolio doesn't need to be protected from volatility. It needs to be protected from yourself." ■

"Volatility refers to how dramatically the price of an investment may change. On the other hand, risk refers to the probability that an investment will underperform the market or result in a permanent loss of capital."

"In short, a stock that sees very large swings in its price over time may be a less risky investment than one that barely moves. The true risk over a long timeframe depends on the underlying business more than the sheer volatility of its share price."

"How much volatility can I tolerate?"

That's the key question that we all need to answer, but it might be the wrong way to tackle the question of temperament.

But I believe most investors should go one step further. In my view, the right question they should ask themselves is:

"How can I better tolerate volatility?"

"The whole reason stocks tend to do well over time is because they make you put up with stuff like this (volatility). It's the cost of admission. A feature, not a bug." - @morganhousel

My fav parts from the four fantastic recommendations in the article.

1■ Invest a fixed amount in any given month.

Rule #1: Invest a fixed amount in any given month

One of the biggest mistakes novice investors make is that they try their luck at market timing. They think that they can not only anticipate economic trends, but also the corresponding effect on stock prices. Anyone who has been exposed enough to financial literature understands that it's a hazardous hobby, and one that can eat away at your long-term returns very fast.

Over the very long term, stocks are going to appreciate and follow GDP growth. If you are out of the market long enough, you are virtually guaranteed to lose.

The futility of timing the stock market is illustrated by the fact that its best and worst days happen close together. Those who claimed they have avoided the worst days will omit that they missed the best ones as well.

Here are the immediate benefits of this approach:

- It's an **automated process** removing any second guessing.
- It **pushes you to invest**, even during months when emotions run high and when you might be tempted to retreat due to fear of a correction.
- It **prevents you from going "all-in"** in a short amount of time, which could diminish future returns if your timing is unfortunate. You may come across a great investment opportunity, but you could always be wrong. Limiting the total you can invest at once **puts a lid on your conviction**.
- Knowing that you will have a fixed amount to invest every month of the year can empower you to **stay the course** when the market inevitably suffers from volatility and large sell-offs of 10%, 20% or even 30% from its previous high like it did in March. You are more likely to look forward to accumulating more shares when the market falls.

Overall, a fixed amount invested monthly is **forcing your way** into the market, but at the same it's **easing your way in**. And it removes all judgment from the equation. It puts you in a position where you will be forced to **stage your buys**, even in your highest conviction, and stay cool-headed.

2■ Define your max allocation to a stock

Rule #2: Define your max allocation to a stock

One of the easiest ways to avoid being carried away by your own convictions is to cap your maximum exposure to a single company from a *cost-basis* perspective. What really matters is not so much the number of stocks you own, but rather the largest amount you are letting yourself add to a given stock.

If you focus on your risk allocation from a *cost-basis* perspective rather than your *current* value, you will benefit from two leverages:

- It will prevent you from adding too much to your losers.
- It will encourage you to add to your winners, even if they have run a lot.

Importantly, with the addition of this simple rule, you are now making sure your emotions cannot dictate your allocation to an individual investment. A very large position will be a result of your portfolio performance, not of your intimate conviction.

3■ Don't add to your losers

Rule #3: Don't add to your losers

I've struggled with this question in the past, and I've found that the best way to avoid having a massive loser in your portfolio is specifically by not averaging down.

So many investors have destroyed their portfolio by averaging down on losers, time and time again, turning what should have been a 2% position going down to zero into a 10% or 15% position going down to zero.

But what's a loser, really?

When I talk about adding to losers, I'm referring to the temptation we all have to "double down" on a position that's down significantly from our cost basis, so that we can break even faster. That's what I want to avoid at all costs.

Diversification is a fantastic tool to avoid over exposing your portfolio to an individual threat. We already covered this with Rule #2. But even if you avoid adding too much to an individual stock, you might still add consistently to your losers. They might end up representing a large portion of your portfolio collectively.

Leaving your losers well below the maximum allowed could make a critical difference over time in your portfolio construction and its resulting performance.

Letting yourself average down all the way to your maximum allocation on all your losers is how you end up with a well-balanced portfolio... of losers. Not a great proposition, if you ask me.

It's perfectly natural to be willing to add to losing positions because of this illusion that they will recover to our initial cost basis quickly. Yet, avoiding this practice altogether can virtually guarantee that your losers will remain infinitely small positions. They should all lie at the bottom of your portfolio, with little funds added to them, and little impact on your overall returns.

4■ Don't sell your winners

Rule #4: Don't sell your winners

Charlie Munger once said:

> *The first rule of compounding: Never interrupt it unnecessarily.*

With years needed for the beauty of compounding to do its magic, the stomach needed to be able to cope with large draw-downs is an essential tool in the arsenal of the growth investor. I recently touched on this in my

We are all hardwired to sell our winners to secure our gains, potentially forgoing a much larger investment profit over time. I've covered before The Art of Not Selling and why the mistakes that will most impact your performance are likely to be decisions to sell too soon. Creating a rule to prevent this natural tendency is a powerful way to truly unleash your portfolio's potential.

Investors can always find a reason to sell a stock:

- The CEO is leaving.
- Insiders are selling shares.
- The guidance is disappointing.
- Next quarter will have tough comps.

Most of the time, these reasons have little to do with the long-term potential of an investment and more to do with the fragility of one's conviction.

If you are ready to part ways with your share the second a CEO steps down, your portfolio is in for a wild turnover over time.

If one bad quarter is enough to re-assess your opinion of a business, I hate to break it to you, but you will never hold a business for more than a few years.

Recognizing that most things in life are not linear is an essential step to embracing the unknown as an investor. If you currently own a future 100-bagger in your portfolio, the path to get there will probably be full of pitfalls.

My personal conclusions out of this research are what is driving a core aspect of my investing philosophy:

1. Alpha is driven by a very small amount of outstanding performers.
2. Don't sell your winners. Instead add to them over time.
3. Accept that you'll have losers. Statistically around 40% of your picks.

This core idea that you *let your portfolio concentrate for you* through its sheer performance is one that I've covered in my article about VC strategies. Venture Capitalists have a diversified approach with investments in many start-ups. But their performance is driven by the few of them that turn into unicorns or decacorns.

By not selling your winners, you are letting your most precious source of alpha do the work without interruption, even when your stomach tells you otherwise.

Conclusion ■

With the four rules discussed today, I've covered both ends of the spectrum:

1. My investments are staged over time.
2. I avoid throwing too much at my highest convictions.
3. I don't let myself pile up on my losers.
4. I hold on to my winners for years, letting them take over my portfolio.

Investing is not easy, but it should be simple. With safeguards on the way funds enter and exit the portfolio, I believe you are well covered.

Finding great investments is relatively easy. It's holding on to them and maintaining a diligent portfolio strategy all the way through that is really challenging.