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Do you choose the blue pill or the red pill?

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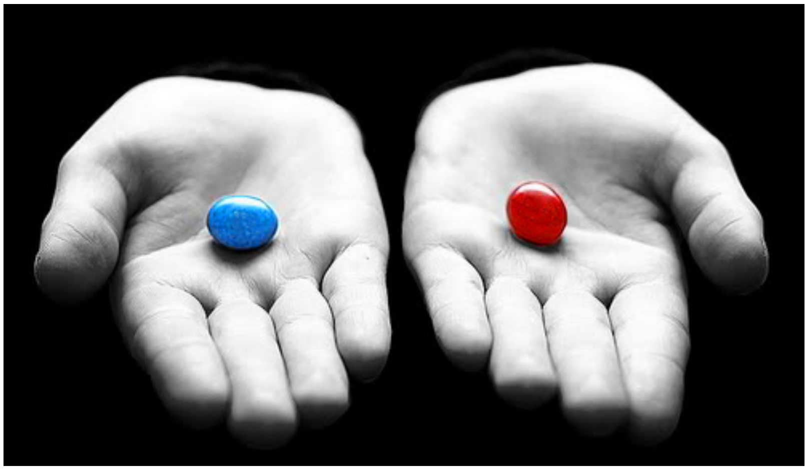

I have been talking to a financial planner recently who is struggling between the red pill and the blue bill.

On the one hand, the poor performance of stock and bond indexes over the past decade or so, particularly the losses in bear markets, led him to study long-term market cycles. An understanding that markets don't always go up over long periods is the reality of the red pill.

On the other hand, much of the investment industry still believes in getting "market returns" and that a simple plan of "asset allocation" and occasional re-balancing is prudent enough, so a financial planner can choose to keep his practice simple by continuing that plan. Some investment advisers even consider re-balancing and an occasional change "tactical". It isn't.

The blue pill and the red pill are opposites, representing the choice between blissful ignorance of illusion (blue) and embracing the painful truth of reality (red).

On the one hand, after understanding the trends of global markets based on simply looking at their history, he realizes the probable outcome of stocks and bonds based on trends I discuss in [The S&P 500 Stock Index at Inflection Points] and [133 Years of Long Term Interest Rates]. Though price trends can continue far more than you expect, the stock and bond markets are at a point that their trends could reverse. The financial planner realizes if he takes the red pill of reality, he'll have to embrace these facts and *do something rather than sit there*. He'll have to change his long-held beliefs that markets are efficient and the best you can do is allocate to them. He'll have to do extra assignments and homework to find alternative investment managers whose track record suggests they may have the experience and expertise to operate through challenging market conditions.

On the other hand, changing ones beliefs and taking a different approach can be extra work and have risks. If he continues the static asset allocation to stocks and bonds he's always done, he says he won't be doing something so different from the majority of advisers. He knows his career and his life will be easier. When the markets go up, his clients make market returns (minus his fees). When the markets go down, other people are losing money too, and he certainly can't control what the market does, so: *it's the market*. I can see how this is an enticing business model, especially for a busy person who has a life outside the office. That's probably why it's so popular.

A similar theme of duality happens in the movie *The Matrix*. Morpheus offers Neo either a blue pill (to forget about The Matrix and continue to live in the world of illusion) or a red pill (to enter the sometimes painful world of reality). Duality is something consisting of two parts: a thing that has two states that may be complementary or opposed to each other. We all get to choose what we believe and our choices shape the world we individually live in.

I can't say that I can totally relate to the financial adviser because it is my nature to be more tactical and active in decision-making. I believe we should actively pursue what we want. And, I believe what we want from the markets is in there, I just have to extract it from the parts we don't want. I once explained my investment strategy to a life-long friend and he replied "you have always been tactical" and reminded me of my background. Though it's different from me, I can truly appreciate the struggle advisers and investors face choosing between the red or blue pill. Investors and advisers like "market returns" when they are positive, which is what we experience most of the *time*. It's when those markets decline that they don't want what the market dishes out. The markets don't spend as much time in declines. I pointed out in The Real Length of the Average Bull Market the average upward trend for stocks (bull market) lasts 39 months while the average decline (bear market) is about 17 months. Investors eventually forget and become complacent about the time they need a reminder. Though the stock markets trend up about 3 times longer than they trend down, it's the magnitude of the losses that cause long-term investors a problem. For example, the bull market from 2003 through October 2007 gained over 105% but the -56% decline afterwards wiped out those gains. You can see that picture in The S&P 500 Stock Index at Inflection Points.

The risk for the financial adviser who has historically focused on "market returns" is that a new strategy for them that applies some type of active risk management is likely to be uncorrelated and maybe even disconnected at times from "market returns". For example, I discussed that in Understanding Hedge Fund Index Performance. Investors who are used to "market returns" but need a more absolute return strategy with risk management may require behavior modification. If they want an investment program that compounds capital positively by avoiding large losses and capturing some gains along the way they have to be able to stick with it. That requires the adviser to spend more time educating his or her investors about the reality of the red pill. Kind of like I am doing now. Some people have more difficulty doing something different, so they need more help. Others are better able to see the big picture. Some financial advisers would rather deal with explaining the losses when markets decline. For them, it can be as simple as forwarding his or her clients some articles about the market going down with a message something like "We're all in this together – let's just hunker down". That doesn't require a great deal of independent thinking or doing. While most individual investors probably do lose money when the stock and bond markets do, that isn't the case for those who direct and control downside risk.

It isn't enough to have a good investment program with a strong performance history. Just as important is the ability to help investors modify their beliefs and behavior. That is the reality of the red pill. By definition, *active* is more work that passive. Investors and advisers alike get to choose which pill they take: the blissful ignorance of illusion (blue) and embracing the painful truth of reality (red). I believe in individual liberty and personal responsibility, so the choice is your own. But my thoughts on the subject are directional – I *am* the red pill.

Morpheus: "You have to understand, most of these people are not ready to be unplugged. And many of them are so inured, so hopelessly dependent on the system, that they will fight to protect it."

Like *The Matrix*, this is going to be a sequel.