The Three Pockets Approach to Investing

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The secret to investing successfully is no secret; many investors have heard it already. The problem is that too many investors still do not practice it.

Simply put, if you invest over a period of time, properly diversify across a variety of asset classes and leave the portfolio relatively stable, it will undoubtedly grow at a greater rate than by leaving it in the bank, but with much less risk than trading.

Why is it that so many people don't follow such a straightforward plan?

One answer is that investors lose money by actively trading. It is human nature to want to succeed. It is this drive to excel that has made human beings accomplish so much. But there are two reasons why looking at investing as a competition can lead to problems.

When you compete, there has to be an agreed-upon time frame to decide who won, usually quite short. So the "long term" naturally becomes no longer than one year. But when it comes to building safety into a life investment plan, one-year horizons, and even five-year horizons, can be too short. It turns out that asset classes are often on cycles of a decade or more, and it is hard to know when they will turn. As long as you stay invested in a broad base of different classes, you don't have to worry about timing, as the package of classes will result in positive long-term growth throughout your life. But the average investor can't resist the urge to compete. So he often ends up trading way too much of his nest egg into over-concentrated positions.

Watching and leaving alone a broad-based package of asset class investments—built up slowly during your accumulation years and then slowly liquidated over the rest of your retirement years—is actually quite boring.

Conversely, there is the other type of investor who is constantly in fear of losing their money and simply can't sleep at night if any of their funds are exposed to volatility. Yet volatility over time is where you can make more returns than in assets that never fluctuate. So, sadly, this type of person ends up getting no long-term growth and may end up short when they are in their later years.

Timothy McCarthy, the author of the book "The Safe Investor: How to Make Your Money Grow in a Volatile Global Economy" (Palgrave Macmillan, 2014), developed an approach for investors to better reflect what they often want to do instinctively while keeping their portfolio goals on track. He calls it Three Pockets.

From a risk management standpoint, using the Three Pockets approach can help you feel comfortable that irrespective of what the world throws at you in the coming years, your money will ultimately grow. And at the same time, it has enough built-in enough flexibility to allow you to follow your unique dreams in a reasonable fashion.

McCarthy's Three Pockets are savings, investing and trading. His explanation of each is as follows.

The Savings Pocket

The first pocket helps an adviser work with an investor to find out how much money they really need to keep in their Savings Pocket. This pocket has two objectives:

- No volatility, no risk of losing principal; and
- Highly liquid, you can get it out any business day.

Of course, everyone needs a Savings Pocket, for short-term needs and in case of an emergency. The question is, how much should stay there? After all, this pocket cannot grow, given how low interest rates are.

How much in this pocket is enough? It really depends on each person's personality and short-term needs, but typically for a retired person, having around six to 12 months of your expected expenses in this pocket is sufficient.

You may feel you need more but remember: There is a portion of your investment pocket that is still growing but is invested in relatively liquid and low-volatility assets that will be available to you if you need it.

The Investing Pocket

This is where the bulk of your money should be. The objective in this pocket is to:

- Grow your money at a greater rate than your Savings Pocket,
- But with less risk than your Trading Pocket.

How do you accomplish this task? You just do the following:

- Invest in a broad group of asset classes domestically as well as internationally.
- Practice “trickle in/trickle out” (e.g., build your investments ideally over a 10- to 20-year period prior to retiring). Then, after retiring, only take out each year what you need to live off of. Figure 1 illustrates this concept.

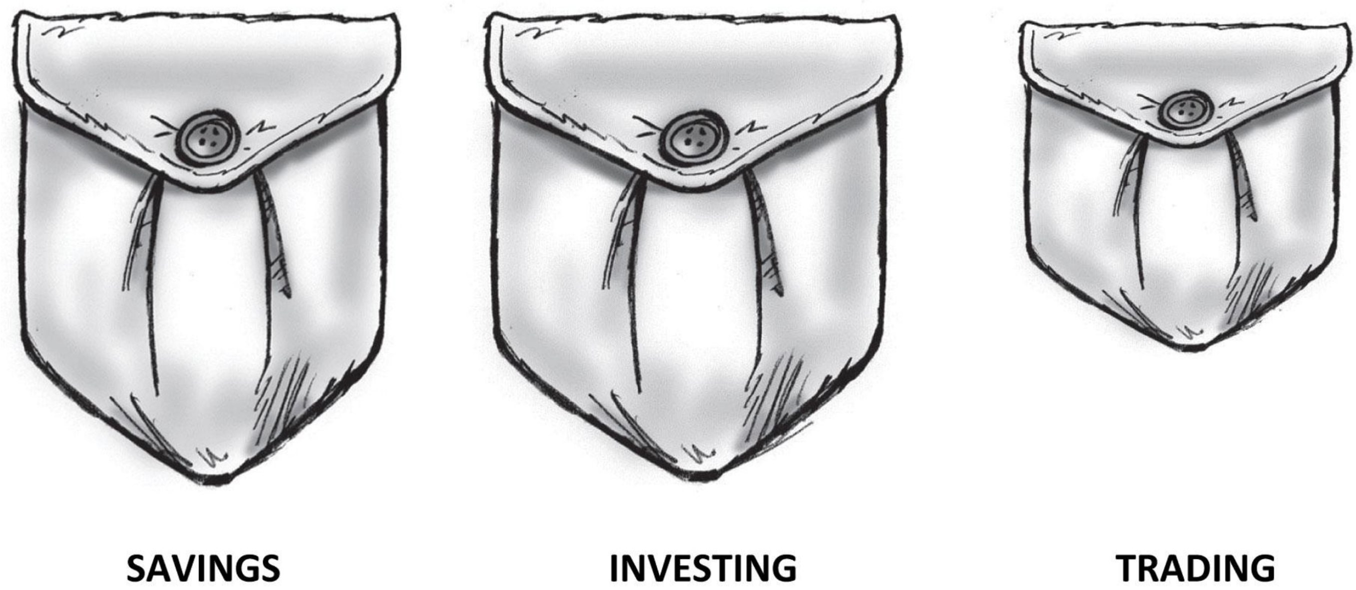

Figure 1. The Three Pockets

- Make no dramatic shifts in asset classes in any one year. Allow time to work its magic.

How do you know it will work? Looking at the last century of data, the worst time that you could have been fully invested in a diversified package of asset classes including stocks and bonds was 1930, when the stock market dramatically crashed and took a long time to recover. If you had followed the strategy of trickle investing each year—in this case, starting to invest 15 years before retiring, and then, after retiring in 1930, slowly trickled out the same amount that you had been putting into your diversified Investing Pocket, you didn’t run out of money until you were well into your 90s. Whereas if you had had only a Savings Pocket where you had put all your money only into the bank, you would have likely run out of money in your mid-80s.

Why is this so? It turns out that markets typically crash after a recent run-up. And the major markets throughout time typically do return to a more stable path. Thus, as long as you had spread out your investing into the various markets over a period of a decade or more, didn’t panic, and each year redeemed only the portion you needed to live off of, you did just fine even if you had bad timing luck.

For many people, especially after they have retired and can’t make back their money, it is scary to see markets drop. But as long as you bought over a long period of years, you will never have bought on average even near the top. And as long as you don’t panic and sell, you don’t lose what you don’t sell. And the global markets, at least for the majority of the asset classes, do come back.

The Trading Pocket

This is your discretionary pocket. You don't need to have one; however, this pocket can take care of a few important objectives.

You can concentrate your investments, either by taking a big position in a particular stock or by believing that a particular asset class is going to bring a far superior return. For instance, you may say, "China is undervalued. I am going to make a big bet on its stock market rebounding."

You can make the investment timing decisions here. For instance, you may say, "Now is the perfect time to go into China. I think that within the next month, the stock market will shoot up."

Given the natural dangers in this pocket, it is typically not wise for investors to fund the Trading Pocket until after they have properly funded their Savings Pocket and Investing Pocket. The money that goes into here is the money that you can afford to lose. For instance, if you hit it big in this pocket, you can vacation in Hawaii. But if you lose your money in this pocket, you will just be barbecuing in the backyard this summer. The important point is that your long-term retirement nest egg is not put into jeopardy by what you do in this pocket.

The Trading Pocket can be a great tool for both the risk-seeking and, ironically, the risk-averse investor.

First off, for risk-seeking people, this is where they can channel their urge to excel. It is okay to make bets here as long as it does not affect the core investment portfolio. Even when someone is good at trading, his or her spouse may say, "Honey, you are a good investment manager. But maybe you should not be our only manager."

Discussing the Trading Pocket is a good exercise for people. For instance, when someone says, "I want to invest, but is this a good time?," the best reply is that it is the right question for the Trading Pocket. But for the Investing Pocket—since you should regularly be trickling in and trickling out over the decades, irrespective of market timing—it is not a relevant question.

Ironically, the Trading Pocket can also be quite helpful to risk-averse investors. For instance, if you are the type who often worries about the markets collapsing, just fund the Trading Pocket each year with a small amount of money invested in, let's say, in the U.S. stock market, above what you have already invested in your Investing Pocket. Then, when you panic, you have something that you can sell off. Just sell all or half of what is in your Trading Pocket and put it in cash. That way, you will feel good that you did something, yet it kept you from touching your Investing Pocket. The Trading Pocket can act as a useful "panic pressure release valve."

How much can a person put into the Trading Pocket? The most important guideline is to first fund the Investing Pocket enough so that when you retire, you know you will have enough to live off of. But if you don't have the patience to wait until after the Investing Pocket is funded, then just make sure you are only putting a small portion, less than 20% of your available investing money, into your Trading Pocket.

Normally, when people are retired, even if they are affluent, they should keep less than 15% to 20% of their total funds in this speculative pocket. But there are of course valid exceptions.

→ **Timothy McCarthy** is the author of the book **"The Safe Investor: How to Make Your Money Grow in a Volatile Global Economy"** (Palgrave Macmillan, 2014).